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Moldova Economic Growth Analysis

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Key Policy Messages

- Our independent assessment is that macroeconomic policies are currently adequate for the short- to medium-term economic growth of Moldova. While some policy tools can be discussed (such as adequacy of the budget deficit, or of the exchange rate policy), the macroeconomic policy reached a 'good' equilibrium and no significant boosts on the economic growth should be expected from altering in one or another way the most basic policy tools. The policy discussions should rather concentrate on the structural, institutional, infrastructural and climate risks and weaknesses constraining the economic growth.

- While risks and uncertainties still persist in European and global economy, it seems that the peak had been already achieved and Moldova is currently on its light recovery path from external shocks as our own Economic Leading Indicator[1] has stabilized during the third quarter after a constant fall since October 2011. For the following two – three quarters the main negative repercussions on Moldovan economy will derive from the dramatic situation in the agricultural sector and its implication on food processing industry. In this respect, we would like to draw attention to the fact that the vulnerability of the economy to the increasingly more extreme weather has been the most constant feature of Moldova in the recent two decades and has eaten away about 20-25% of the Moldovan GDP. Strategies and plans adopted so far for reducing this vulnerability has brought little effect; a much sober assessment of the agriculture climate exposure and a revision of the agricultural development paradigm are highly necessary.

- The fallout from agricultural recessions usually hit the downstream sectors, such as food processing industries. There has been a persistent impact observed in result of every drought that hit Moldova after 1991, mainly due to weakening domestic supply chains. The protection customs tariffs applied on imported agricultural raw materials only make the food processors' logistics problem even more costly. The involved policy authorities (Ministry of Agriculture and Ministry of Economy) may reconsider how adequate is the trade policy during or after large-scale events affecting the food industry supply chains and to allow for temporary reductions in the customs duties.

- While Moldova has seen its 'investors' protection' rating dramatically improved in the Doing Business 2013, this is not convergent with the generalized perception that the property in Moldova is actually well defended by the law. National media abounds in numerous stories of attempts of hostile corporate takeovers, corporate scandals, and CEOs lack of responsibility. This calls for a professional revision of the commercial and corporate law in Moldova and for better training of the judges' ruling on commercial and corporate matters.

- In uncertain economic times the economic and budgetary forecast are difficult even for the governments having better forecast capacities than the Moldovan one. However, it is imperative to start consolidating these capacities in three institutions which play a key role in the economic policy and especially in the budgetary planning – the Ministry of Finance, Ministry of Agriculture and Ministry of Economy. The consolidation of the forecasting and planning capacities is only possible if paralleled by consolidation of the ex-ante policy impact assessment skills. Aside from developing own capacities, these institutions have to learn to better coordinate their policy planning and, indeed, to try to adopt a wider perspective on the policy and forecasts, a perspective which normally should go beyond their 'sectors'.

[1] „The relevance of Composite Leading Indicator elaborated by Expert-Grup in defining the fluctuations of Moldovan economy", Expert-Grup, 2012, http://expert-grup.org/?go=biblioteca&c=28

- In our opinion the two most important preconditions for a long-term growth and development of our country are justice and education sector reform, currently negatively affecting the functioning of Moldovan economy. Only a fair justice sector can ensure the functioning of all other structures of an economy, support its growing complexity and sophistication and in this way allow for higher and long-term economic growth, given the already proven impact of quality of institutions on economic growth. On the other hand, the most important endowment of the resource-poor Moldova is its people and the Moldovan economy can function well only with more of its people becoming part of the economic processes. In its aspiration to become a competitive and innovative economy Moldova has no chances to perform well if the human capital base is continuously eroded through emigration and through the continuously deteriorating quality of education. It has already become clear that the educational system does not answer to the economic needs, the deficit of well-trained and qualified human capital aggravating during the last decade.

Statistical Indicators

Table 1. Moldova: key long-term economic and socio-economic indicators

	2009	2010	2011	2012 estimate	2013 forecast
Population, million (excludes Transnistria), beginning of the year	3.568	3.564	3560.4	3553	3553
GDP, billion MDL, current prices	60.429	71.849	82.174	87.953	95.583
GDP, billion USD, current prices	5.409	5.810	7.003	7.269	7.647
GDP per capita, USD at PPP	2843	3088	3373.0	3383.1	3603.7
Real GDP, y-o-y % change	-6.5	6.9	6.4	0.5	3.5
GDP deflator, y-o-y % change	2.0	11.2	7.4	6.5	5.0
Private consumption, y-o-y % change	-7.9	9.0	8.5	1.3	3.2
Gross fixed capital formation, y-o-y % change	-30.9	17.2	10.7	-0.8	5.0
Industrial production, y-o-y % change	-22.2	7.0	7.4	3.0	6.0
Agricultural production, y-o-y % change	-9.9	7.9	5.8	-20	17
Share of industry in GDP, %	13.0	13.3	13.7	13.4	13.7
Share of agriculture in GDP, %	8.5	12.0	12.3	10.0	10.5
Merchandise FOB exports, million USD	1331.6	1541.5	2221.6	2320	2390
Merchandise CIF imports, million USD	3275.8	3855.3	5191.6	5134	5160
Service exports, million USD	673.1	701.2	868.8	896	920
Service imports, million USD	712.9	770.9	894.7	979	1010
Net foreign direct investment, million USD	138.6	193.9	253.4	n.a.	n.a.
Net work remittances, million USD	1198.6	1351.4	1600.4	1648.0	1698.0
Current account/GDP, %	-8.6	-7.9	-11.5	-7.6	-8.2
Official reserve assets, end-year, million USD	1480.3	1717.7	1965.3	2100	2200
Total external debt stock, million USD	4364.1	4778.7	5452.3	n.a.	n.a.
External debt/GDP, %	80.8	82.2	77.9	n.a.	n.a.
Employment rate, % of population aged above 15	40.0	38.5	39.4	38.0-39.0	39.0-40.0
Unemployment rate, % of economically active population	6.4	7.4	6.2	5.8	6.4
Real wage growth rate, y-o-y % change	9.0	0.7	3.7	1.0	3.0
Consumer prices index, year end, y-o-y % change	0.4	8.1	7.8	5.2	4.5
General government balance, % of GDP	-6.8	-2.5	-2.4	-1.8	-1.0
General government expenditure, % of GDP	45.3	40.8	39.1	41.4	41.3
Exchange rate, year average, MDL per USD	11.1	12.4	11.7	12.1	12.5
Broad money (M2), y-o-y % change	-3.8	18.3	14.4	20.0	15.0
Central bank refinancing rate, end-year, %	5.0	7.0	9.5	4.5	5.5
Total commercial bank loans, % of GDP	35.0	32.6	36	32	33
Bank deposit rate, %, average per year	14.7	7.6	7.54	7.6	7.7
Bank lending rate, %, average per year	20.3	16.3	14.4	13.5	13.0

Source: NBS, IMF, NBM and EXPERT-GRUP calculations, estimates and forecast;

Summary

Domestic Supply
In 2012 Moldovan economy has been victim of external financial hazards (fallout from the EU sovereign debt crisis), weather shocks (extended and severe drought) and domestic weaknesses (poor business conditions and sluggish demand). The economic growth has moderated tremendously, with the expected annual figure of only 0.5% in the GDP growth. We expect a better economic outlook for 2013, with the GDP forecasted to rise by 3.5% in the basic scenario; however, a more sober 2.0% growth is also possible provided that European consumers and labour markets continue weakening. The growth under the basic scenario will be brought about mainly by a 10% to 15% recovery of the agricultural sector (under the assumption of a 'normal' climate next year), a relatively modest 5% growth in industry and constructions, and an expected 2.0% growth in the volume of the services sector value-added. Significantly improving domestic business conditions remains the key recommendation for unleashing the domestic economy potential.

Domestic Demand
For the first time after the 2009 decline, the household consumption fell due to the worsening situation on the national labour market and declining transfers from abroad in favour of natural persons. While the decline in remittances is currently generated by the difficulties in Euroarea, the CIS economies are not immune to the evolutions in EU countries either and in the second quarter the remittances from CIS, including Russia grew twice lower compared to 2010 and 2011, while remittances from other countries than CIS fell by 5.6%. The cooling down of consumption influenced negatively the firms' activity, with continuous increase in inventories. This situation reflects the difficulties companies face in selling the production stocks and might result in decrease of production in the following quarters if the inventories consist mainly of finite production. The investment activity, though less anaemic compared to the first quarter, is seriously affected by lack of foreign investment that continues to fall for several quarters in row.

Public Finance
Most of the attempts to ensure the fiscal consolidation in 2012 targeted the revenue side of the state budget: reintroduction of the 12% corporate income tax, excise raises for a series of products. The international community's strong support in the form of grants and loans served as an additional pillar for maintaining the stability of public finances. Nevertheless, consolidated actions are necessary to substitute these short-term sources with pillars aimed at ensuring a long-run equilibrium of the state budget. Particularly, the Government has to significantly improve the efficiency of tax collections, custom and fiscal administration, increase the transparency of the budgetary process, eliminate various tax loopholes, and undertake a comprehensive pension system reform. Another important threat to the fiscal stability is related to the optimism bias of public officials in setting the parameters of state budget laws both for 2012, even after amendments, and for 2013. This creates the risk of having unsustainable spending commitments and higher-than-expected budgetary deficit.

Labour Market
Moldovan labour market evolution in the second quarter of 2012 reflects the external trends that superpose on the 'natural' declining trends in employment in some sectors. Moreover, the decline in employment in all major economic sectors was accompanied by the reduction in employment in formal sector enterprises, determining a social impact of the labour market instability which is significantly higher than just loss of jobs. This is amplified by the loss in social protection mechanisms by many individuals staying on the labour market, but transiting to informal sector enterprises. Additionally, the evolution of wages points out to the negative perspectives in some export-oriented sectors that might eventually result in jobs closures if the situation on the external markets does not improve. Meanwhile the unemployment rate was quite low, underlining its little relevance in characterizing the state of the Moldovan economy.

Prices and Monetary Policy

The drought repercussions coupled with increasing fuel prices made the annual headline inflation to embark on an upward trend starting from July 2012. The main contribution to this unexpected jump in prices belongs to foodstuffs, which, by the end of the third quarter accounted for about one third of the 12-months inflation. The main causes are related to shrinking domestic supply of foodstuffs due to harsh weather conditions and raising world food prices, which determined corresponding adjustments on the local markets. The persistence of the cost-push inflationary factors amid low demand-side pressures motivated the central bank to leave its policy rate unchanged. In this way, it keeps an accommodative monetary policy stance in order to support lending and mitigate the decelerating economic activity. Due to the recent price hikes, the baseline forecast for the annual CPI has been revised upwards with 5.2% annual increase expected for end of 2012 and 4.5% for 2013, unless new cost-push shocks occur.

Banking Sector

The bank loans stepped on the downward trend due to banks increased reluctance towards lending given the weak economic conditions and lower demand from the part of the firms. One of the main negative evolutions in the third quarter consists in the expansion of bad loans as a share of total banks' portfolios. The biggest concerns are related to two banks which account for about 20% of total bank assets and have over 40% of their credits classified as non-performing. Nevertheless, all commercial banks remained liquid enough for protection against eventual negative shocks hitting the Moldovan economy. The tepid lending activity which will persist till the end of the current year is the main drawback of the banks' conservative approach. Hence, given the high uncertainty and risks, the banks will most probably prefer to store their liquidities in risk-free financial instruments rather than lending to the real sector. While crediting activity is expected to relaunch in the second half of 2013, consolidated actions are necessary in order to ensure a rapid and efficient restructuring of banks' toxic assets by that time.

Foreign Sector

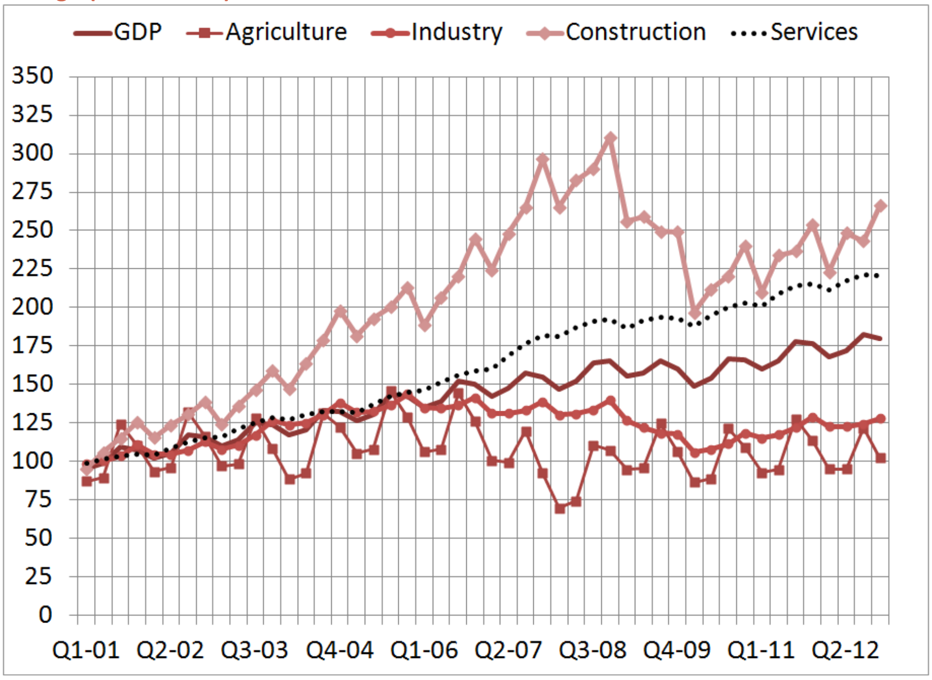
All international financial institutions have revised downwards their global forecast for the economic growth in 2012-2013. For instance, the IMF expects a 3.3% growth for the global economy in 2012 and a sluggish rebound up to 3.6% for 2013. Moldovan foreign trade in 2012 fully reflects the rapidly weakening domestic and external demand, with exports and imports of goods and services expected to rise only about 0.4%, while imports to grow by only 0.1%. Under our main scenario we expect both external and domestic economic situation to improve next year; exports have good chances to grow 4%, while imports will see a slightly stronger push of up to 5-6%. With remittance and other income expected to remain more rigid in the first half of the year, we expect that the current account deficit will go from the expected 7.6% of GDP in 2012 up to 8.2% in 2013.

1. Domestic Supply

Worse economic perspectives in short-term, but slightly better in 2013

The statistical data and estimates on the ***GDP*** show that Moldovan economy has significantly cooled down during 2012 and, as we can foresee now, the short-term prospects remain equally bleak (Chart 1). After the already disappointing growth in Q1-12 (+1.0% y-o-y growth in GDP), in Q2-12 the economic growth lost another half percentage point (+0.6 y-o-y growth in GDP). The preliminary estimates suggest that the in Q3-12 the y-o-y growth of the GDP was about 0.4-0.5%. The Economic Leading Indicator we use for assessing the state of the economy suggests a certain stabilization taking place in July-August, however the downside economic risks are high. *Inter alia*, this is shown by the volume of cargo transport sledging again downwards in September.

Chart 1. Evolution and forecast of the quarterly GDP and its main components, 2002-2012, 5-period moving average (2000=100%)



Source: NBS, forecast for Q2-Q4 2012 by EG;

Agriculture served as the main drag on the economic growth, with a total decline of 7.5% in the gross value-added in the second quarter and an estimated further decline of 15% in Q3-12 (and the third quarter is the one brining the highest contribution to the sector annual output). Obviously, the severe and extended drought that Moldova experienced in 2011-2012 has been the key cause behind this recession. The yields for all major crops plummeted on average 25%, but in some cases even more: yields of corn for seeds declined by almost 70%, wheat – by almost 40%, sunflower and potatoes – by 30%. As we expected in our previous issue of the MEGA, the fallout from the declining crops yields has immediately impacted the livestock sector. In result of shrinking stocks of fodder the producers of eggs and milk have suffered significant shocks: the milk output contracted 4% in Q2-12, while the production of eggs – by more than 20%. We expect that the livestock will show a higher rate of decline in Q3-Q4, as owners are set to meet even bigger problems with feeding the livestock. While the Government declared that the impact of the drought will not affect the food security of the country, the risks for the food security are actually quite high this time for Moldova, considering the fact that in 2012 almost all major countries producing wheat and crops have been hit by the unusually extreme weather. Some of these countries, such as Russia, are even considering introducing total or partial ban of exports of grains. This will immediately lead to higher global prices, which will benefit some of the Moldovan producers, but will negatively affect the purchasing power of all the Moldovan poor, especially in the urban areas.

The Moldovan ***industry*** resumed the growth in the second quarter and generated a 5.3% growth in gross value-added. However, there are clear signals that in the third quarter the growth moderated again, even though remained positive, somewhere between 2-4%. However, several industrial branches are likely to suffer particularly large losses in output, especially those from the food and beverages industry: vegetables and fruits processing and preserving, milling industry and others, which directly depend on the quality and quantity of supplied agricultural raw materials. The tobacco industry has seen its fortune worsening again (with a total decline of 20% in production volume in Q1-Q3-12). The industries based on the so-called outward processing agreements with some European counterparts – such as clothes and shoes production – remained on the downside in the third and final quarters, reflecting the reduced demand on the EU markets. An extended crisis in the EU may bring existential threats for these companies, as their European counterparts may consider looking for cheaper suppliers of the labour services on the third markets (including as remote as Vietnam, Indonesia, Myanmar). The 'newly discovered' Moldovan industries – including electrical equipment, machines, medical tools and equipment, that doubled the level of production in first half of 2012 – remained champions of growth among other industries but, as we expected, their growth rates moderated dramatically in the second part of the year.

Reduction in ***services*** growth has been among the most worrying trends in Q1-Q2–12, with the GVA growth going from 2.6% in Q1-12 to only 1.2% in Q2-12. Our estimates suggest that this deceleration trend stabilized in Q3-12. However, the growth rates will remain much sober than in 2011 both in case of services rendered to the population and those offered to companies. More uncertain economic conditions and fragile cash inflows are the main causes behind the consumers' more frugal behaviour.

After the big surprise in Q1-12 (with a 9.8% reported growth in the sector's GVA), in the second quarter the ***constructions*** sector fared much poorer (only +0.9%, far from what we expected earlier). The main source of growth were the public infrastructure projects (+7.5% y-o-y growth), with almost 46% in total volume of works per sector, while the residential sector has grown more (+8.8%) but it represents a smaller part of the overall output (only 33%). The demand for constructions work from the part of the companies remained as feeble as in Q1-12 (with a -33% y-o-y decline in constructions of non-residential buildings). This reflects the much lower economic confidence of the business and their unwillingness to expand the productive capacities in the context of escalating worries regarding the evolution of the domestic and foreign demand.

Short-term forecast and challenges

- The impact of the drought on the agricultural sector has been just as extended and deep as we thought. Using our simple model regressing agricultural output on areas of crops and weather conditions[2], we maintain our previous forecast that in 2012 the value-added in agriculture will decline by 15% in the base scenario (and about 20% in the worst case). The base scenario will be accompanied by a significant (about 10% on average) rise in farm-gate prices of agricultural products. While some of the farmers will certainly benefit of the growing prices for their products, most of the rural inhabitants will actually suffer and will see their consumption patterns significantly altered. Because of very high uncertainties related to weather, a good forecast of the agricultural production for 2013 is presently difficult to be made. What we expect almost for certain is continuation of the decline in livestock production next year. As time-series data on agricultural output suggest, we may see though a strong rebound in the volume of crops production, provided that in climate terms the year 2013 will be more like a 'normal' one. A 10-15% growth in agricultural output for 2013 may be considered as a basic scenario for the next year.

[2] GVA = 339.888*Areas _Crops – 388292*Aridity_Index, where Areas _Crops is the total surface of areas occupied by annual and multiannual crops, and the Aridity_Index is the ratio between the sum of monthly average air temperatures in the period April-July and the sum of the monthly averages of precipitations in the period November previous year – June current year.

- While the industry has only shown a couple of episodes of positive growth of the industrial production in 2012, most of the companies managed to reduce even more their intermediary consumption. This will continue till the end of the year and, arithmetically, will result into higher than expected growth in value-added (+2%). However, food industry will continue experiencing significant risks related to the weaker supply lines, due to the shrinking agricultural production and will have to rely more on imports. For next year, depending on how quick agricultural sector resumes its growth and on the situation on the European markets, we may see a growth in value-added of up to 5%.

- The growth in the constructions sector will remain on the positive side, even though the growth rate of the value-added is expected to reduce from the 10% in early 2012 to the level of 3% until the end of the year. Predicting the growth of construction volumes for 2013 is very risky because of the very volatile statistical series. We adopt a 5% growth forecast for 2013; however, a double-digit growth is also possible if large public infrastructure projects continue at faster pace.

- The services sector will remain the main source of the economic growth in 2012, with an expected growth in value-added of 1.8%. As in the first half of the year, telecommunications, retail trade and services rendered to the population will support this growth. All in all, we expect a growth of up to 1.8% of the GVA generated by the services sector in 2012 and a slightly more robust 2% growth in 2013.

- On the assumption that taxes on imports and production will grow by about 4-6%, the total GDP at market prices is expected to rise by 0.5%. In 2013, the expected growth of the GDP is about 3.5-3.8%.

Policy recommendations

- Most of our previous policy recommendations remain valid: agricultural policy and the related fiscal policy needs a more long-term and predictable approach, the research and development policy needs to allow for the consolidation of the connections between research community and SMEs, and a more forceful protection of the fair competition combined with better protected consumers' rights is needed.

- The recently released Doing Business 2013 gives a slightly better picture of the national conditions for business, even though some of the findings of the DB 2013 do not correlate with 'real life' perceptions (such as 34 positions improvement in investors' protection, on the background of multiple reported 'hostile takeovers'). On most other indicators Moldova has lost positions. In the general rank, Moldova won 3 positions, going from 86 in 2012 (after back-ward recalculation of the position) to 83 in 2013. Despite this improvement, it is clear that ease of starting a business is the main issue dragging Moldovan economy down compared to other countries and it is really a pity that some of the problems related to lengthy procedure of business registration have not been solved so far. With the creation of the E-Government centre and availability of IT solutions, reducing the length of the business registration to only 1 day is both possible and necessary.

- At the same time, the Doing Business 2013 suggests that dealing with constructions permit remain a problem in Moldova, despite all reforms attempts so far. With no real progress in the curbing the red tape, the Government should not expect a forceful exit of the sector from its current poor condition.

- Reform of the judiciary sector, which was initiated, has to be closely watched by both government and the civil society. A well functioning judiciary is key for Moldova to become more attractive for both domestic and foreign investors, and for the long-term development of the country.

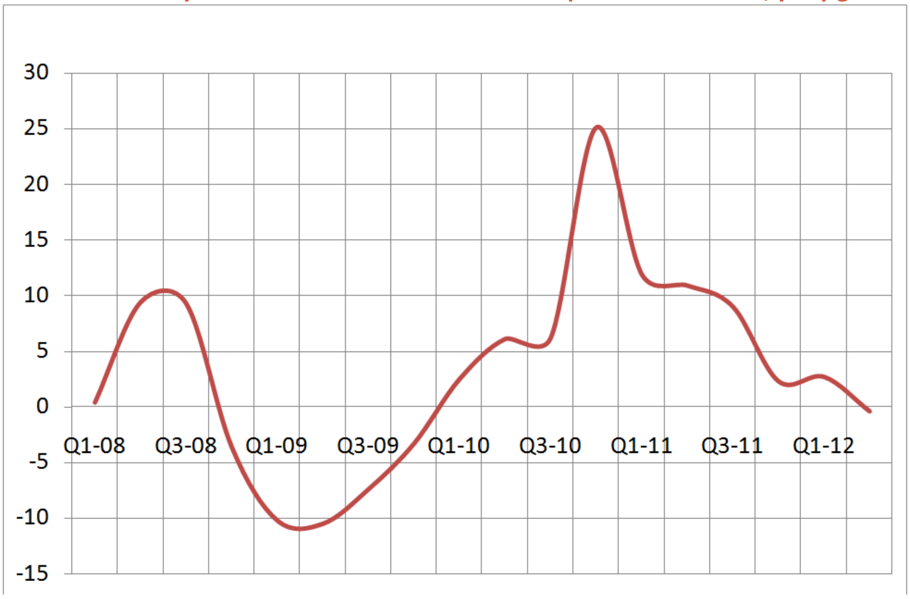
- Another policy recommendation is of reviewing how appropriate is the imports tariff policy, considering the hurdles that companies from the food production sector meet in ensuring the raw materials. Because the domestic production is much smaller in 2012 and uncertain next year, it is advisable to adopt a temporary reduction in customs tariff for the agricultural products imported. This will allow the food processors to substitute the lacking domestic supply with external supply and help overcome the temporary shortages affecting their inputs stocks.

2. Domestic Demand

High volatility of domestic demand: a symptom of weaker economy

As the regional context has not improved and Euroarea countries are still dominated by high economic uncertainties, Moldovan economy performance worsened significantly due to the stagnation of domestic demand in the second quarter. For the first time after the 2009 decline, the household consumption fell. While the decrease was just 0.4% (Chart 2), the impact on economic growth was significant due to its high share in GDP; thus the economy lost about the same amount in percentage points from its overall growth.

Chart 2. Quarterly evolution of households' consumption 2008 - 2012, y-o-y growth, %



Source: Expert-Grup calculations based on NBS data;

Given the not very robust increase in households' disposable income in the second quarter (under 2%), the decline in households' consumption is not surprising, especially that the situation on the national labour market has worsened, with decline in employment, and the transfers from abroad in favour of natural persons went down. While external risks persisted over the recent 12 months, the first decline in the transfers from abroad was registered in the second quarter 2012. Less than 1% decline in remittances is nevertheless important as they explain about 50% of variation in the household consumption[3]. The situation seems to be brighter for the third quarter of the year, with transfers from abroad being back on a positive path for two months in a row: 4.5% y-o-y growth in July and 3.7% in August. Nevertheless, a more prominent rebound of remittances is not expected given the persistent difficulties in the Euroarea (the transfers in EUR are still declining) and worsening forecasts for most of the host-countries for Moldovan emigrants, including Russia[4].

While the decline in remittances is currently determined by the difficulties in Euroarea, the CIS economies are not immune to the evolutions in EU countries either, generating fewer job opportunities and lower salaries for the migrants. As the balance of payments data[5] show, there is a

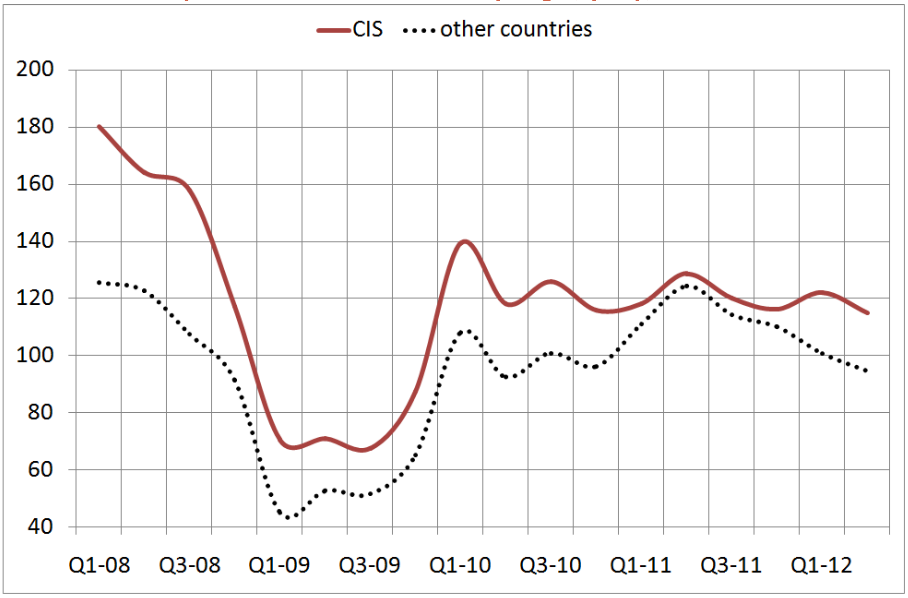
[3] We used a structural vector autoregressive model to forecast final consumption of the households with three endogenous variable (y-o-y growth of final consumption, real y-o-y growth of wages and real interest rates for deposits on deposits) and one exogenous variable (remittances). The forecast error variance decomposition (FEVD) reveals that remittances explain most of variance in consumption, followed by lagged consumption, wages and interest rates;

[4] According to IMF World Economic Outlook from October 2012, the forecasts for 2012 economic growth were revised downwards for EU 27 (-0.2 p.p.) and Russia (-0.3 p.p.);

[5] Data on remittances from Balance of Payments not comparable with the transfers from abroad in favour of natural persons through commercial banks;

very strong correlation between the evolution of remittances from CIS countries and those from other countries (mainly composed of EU countries). Thus, in the second quarter the remittances from other countries went down by 5.6% y-o-y and the remittances from CIS, including Russia, grew at rates 1.5 to 2 times lower compared to 2010 and 2011 years (Chart 3).

Chart 3. Quarterly evolution of remittances by origin, y-o-y, %



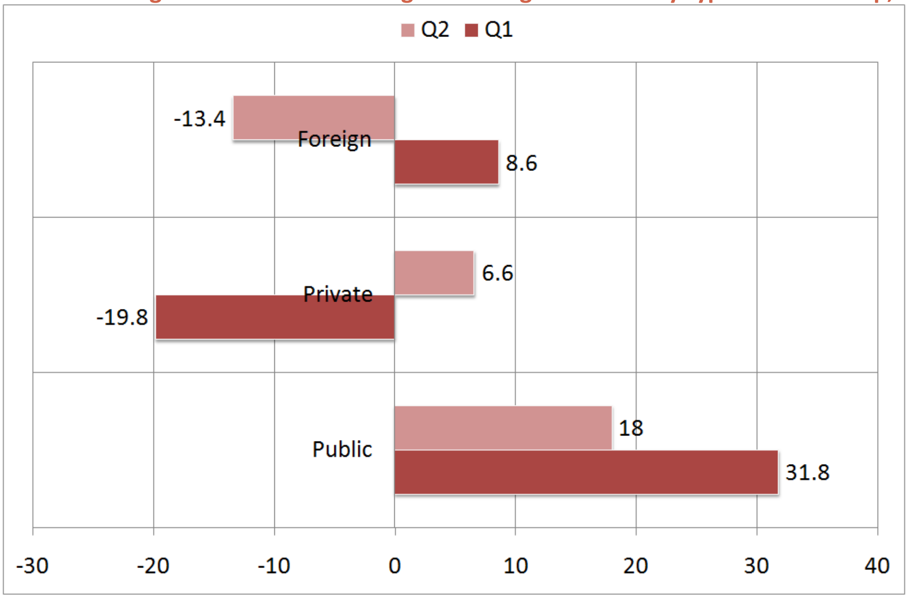
Source: Expert-Grup calculations based on NBM, Balance of Payments data;

While the slight increase in transfers in the third quarter immediately reflected in consumption with a gain in turnover in retail trade and services rendered to the population in July; curiously it has not positively affected the savings of population. In fact, the deposits of the natural persons in the commercial banks continued their downward pattern at much higher rates: 30% y-o-y decrease in July and 26.3% decline in August, with a negative evolution of both deposits in national and foreign currency. This might be an effect of further decline in other sources of income in the third quarter of 2012, especially income from agricultural entrepreneurial activity expected to drop significantly due to the losses for the sector generated by the drought. Therefore, as remittances are primarily channelled to consumption, the saving ratio is declining.

The cooling down of consumption influenced negatively the firms' activity. The inventories continued to rise in the second quarter (for the fourth quarter in a row). While positive change in inventories might induce both optimism and pessimism, the current situation rather reflects the difficulties to sell the production than the positive business expectations regarding future sales. Thus, an increase in the ratio of inventories to sales in period of slowing down or declining consumption (since late 2011) reflects the inability to sell the production stocks and might result in decrease of production in the following quarters if the inventories consist mainly of finite production. If these are mainly row materials or work in progress the situation might have fewer implications on the future production, but also denotes problems related to declining demand.

While the change in inventories was not dramatic in the second quarter, its contribution to gross capital formation was significant, when gross fixed capital formation was 0.9% lower compared to the second quarter of 2011. In fact, the investment activity was less anaemic during this period, with investment in long-term tangible assets increasing by 1.5% y-o-y in the second quarter after a 4.5% drop in the previous one. At the same time the decrease in investment in production capacities (equipment and machinery) was even deeper – about 15%, supporting the argument that firms' have less optimistic short-term expectation. A positive evolution not to be ignored is the fact that investment increased not only in public, but also private ownership, where a significant decline was registered in the first quarter (Chart 4). Nevertheless, the investment in foreign ownership dropped by almost 50%, underlining Moldova's exposure not only to external risks, but also to its domestic weaknesses, which fails to attract investors. The FDI continued its negative path in the second quarter, declining by 26.3% on annual basis.

Chart 4. Change in investment in long-term tangible assets by type of ownership, % y-o-y



Note: Investment in foreign ownership includes investment in foreign and mixed (domestic and foreign) companies;
Source: Expert-Grup calculations based on NBS data;

Short-term forecast and challenges

- As the situation on the external and domestic markets has not improved in the second quarter and actually some negative trends on the European labour market accentuated, our forecast for the households' income has slightly worsened. We still expect the disposable income of the population to stagnate this year, with remittances increasing around 3% in 2012 and 2013. The more pessimistic forecast derives from the downward update for the EU and Russia economic growth for 2012 and 2013[6].

- Consequently, this will have a significant impact on households' consumption that we expect to grow between 1.3% and 1.8% by the end of 2012, thus, narrowing the interval of our last forecast that also had an optimist scenario of 3.2% growth. For 2013 we expect consumption to grow faster, but still at lower than usual for Moldova rates - 3.2%.

- The short-term evolutions of capital investments are highly dependent on the further developments in the Euro area and the moment consumption resumes. As for the medium and long-term, the investment activity depends on the internal situation in the country. It might take some time for companies to be able again to invest at rates similar to those in 2010 and 2011, but even this level is not sufficient for Moldova's sustainable growth. For higher investment Moldova needs a more favourable business climate. Although higher public investment in 2012 and 2013 are expected, the external risks persist and some of the planned investments may not succeed because of too optimistic budget for 2012 and 2013. If the situation does not improve some budgetary cuts will be inevitable.

[6] The forecast is given by the results of ARIMA model for remittances (from Balance of Payments) and transfers from abroad in favor of natural persons (NBM data) on a time series of 46 quarters (2001:1 to 2012:2). Each variable was expressed in logarithmic terms. Hence, the transfers were modeled with seasonal ARIMA model (0,1,4)x(0,1,0), while the remittances with seasonal ARIMA model (1,1,0)x(0,1,1) and ARIMA model with 2 exogenous variables: growth rate of EU and CIS GDP;

Policy recommendations

- As the general situation has not changed too much since the issue no. 6 of MEGA was launched, the previous policy recommendations are still valid. In order to support domestic demand and avoid high volatility in consumption Moldova needs a more healthy economy with more revenues generated within the country. This generally implies creating a more friendly investment climate with honest competition, reduction of transaction costs and removal of informal payments. This would ensure more employment opportunities, higher share of incomes generated in the country and increase in consumer utility by getting higher quality goods and services at lower prices.
- The need to change the social protection mechanisms in order to reach the most vulnerable and to ensure their full integration in the society, not only take a functional approach aiming to cover the physiologic needs, remains valid. It may actually increase in the rural areas, where the situation might worsen by the end of 2012 due to evolutions in the agricultural sector.
- Public investment in infrastructure should be a priority for the next years, but the state should not overestimate its capacity to finance them given the existent uncertainties in the global economy. Meanwhile, maximum transparency should be ensured in the public investments procedures in order to use efficiently scarce money and to win the trust of the taxpayers that might further finance the investments.

3. Public Finance

Optimism-bias in public forecasts: a risk for public finance stability?

The economic slowdown and, particularly, cooling of domestic demand took its toll on public revenues, mainly through the channel of indirect revenues. Lower consumption and imports caused the collections of VAT, excises and custom duties (which together account for over 70% of total state budget revenues) to perform under the planned levels. As of August 2012, the total public revenues were 2.9% lower than the planned level, being primarily determined by poor tax collections for the imported goods and services. VAT collections from these products were 5.1% below the plan and the excises' – 8.6% below (Table 2). This underperformance was partly determined by the over-optimistic forecasts of the state budget revenues. Even the mid-2012 downward amendment of the state budget has been based on an estimate of economic growth of 3% for the end of the year, which was almost three times higher than the Expert-Grup forecast at that time (see the issue no.6 of MEGA).

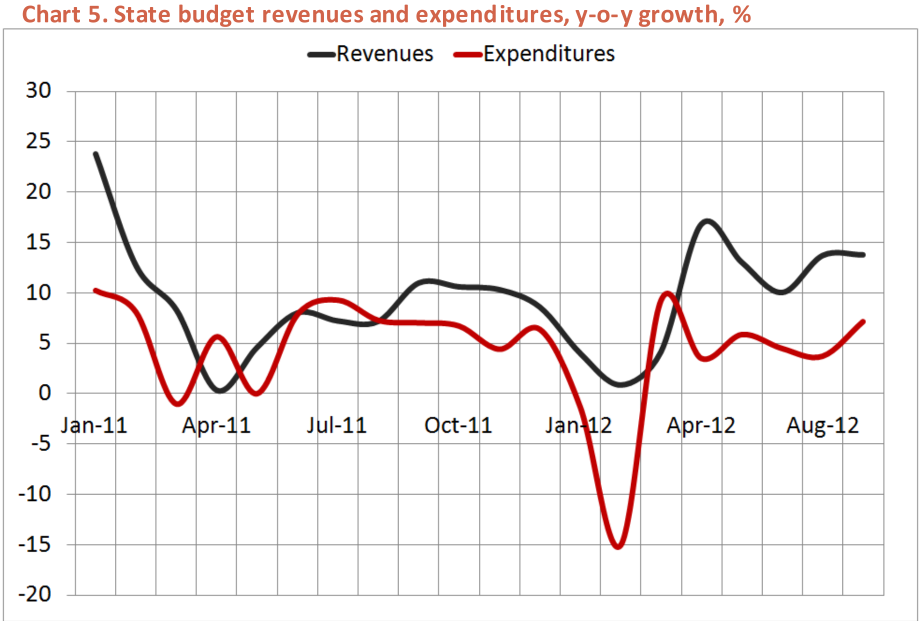
Table 2. Collected revenues for the period January - August, 2012, as a share of planned revenues, %

Type of tax	Collected compared to the plan
Income tax	113.4
VAT, total	97.1
VAT from imported products	94.9
Excises	91.4
Road taxes	97.2
Custom duties	99.9
Other non-fiscal revenues	98.6

Source: Ministry of Finance;

The reintroduction of corporate income tax and excises' rise for a series of products applied from the beginning of 2012, coupled with a massive inflow of foreign grants have partly compensated losses from VAT collections. In January - August 2012, the collections from excises were 19% higher, those from foreign grants – more than twice higher and the revenues from corporate income tax – by 2.7 times higher compared to the same period of the previous year. Finally, the y-o-y growth of total state budget revenues constantly exceeds the level of expenditures (Chart 5) which augurs well for further equilibration of public finances until the end of the current year.

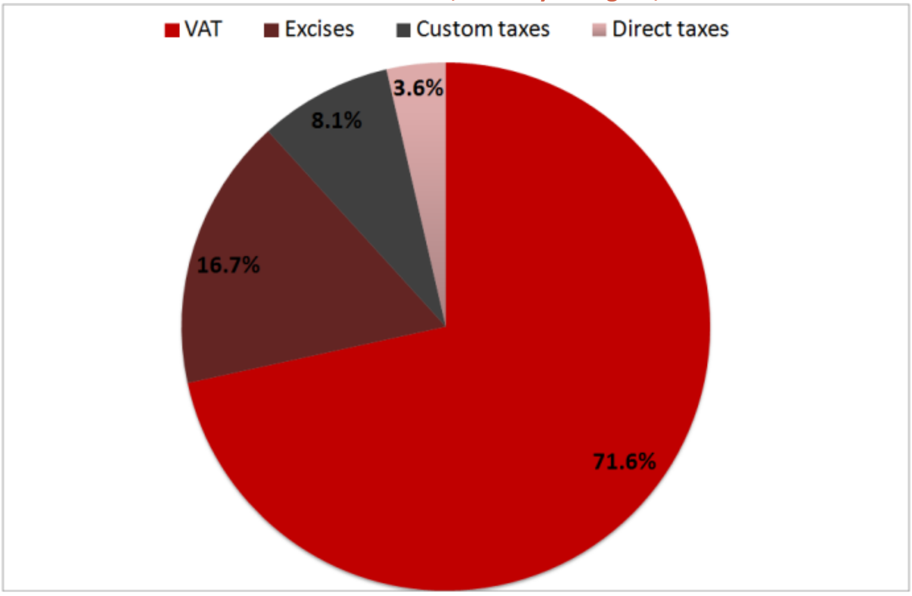
Chart 5. State budget revenues and expenditures, y-o-y growth, %



Source: Ministry of Finance and EG calculations;

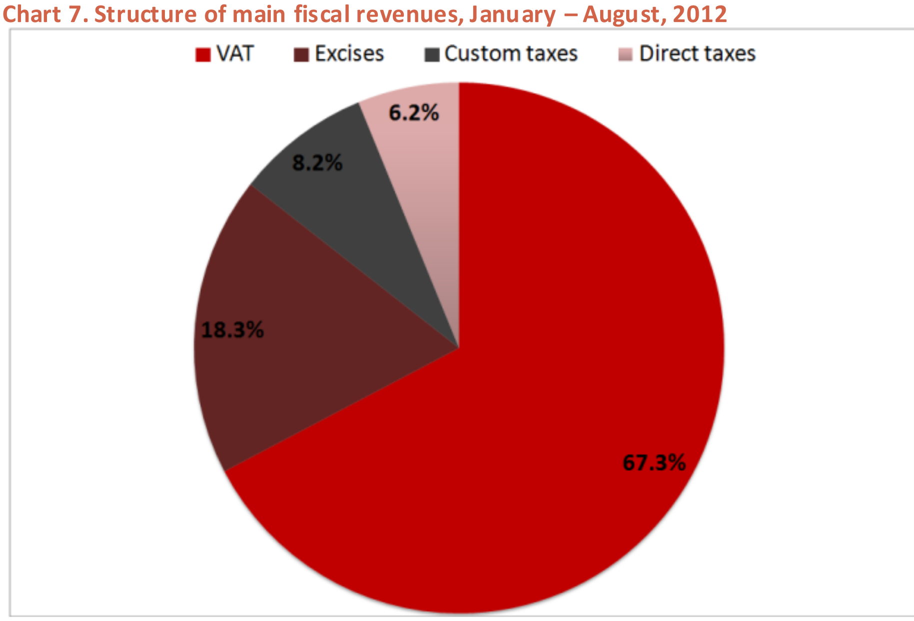
Chart 6 and Chart 7 clearly reveal the impact of the recent administrative measures on the structure of fiscal public revenues. The share of VAT collections in the period January – August 2012 was 67.3%, down from 71.6% last year. Role of excises became slightly more important (with the share increasing from 16.7% to 18.3%), while the share of direct taxes almost doubled, mainly due to the contribution of the reintroduced corporate income tax. Such a structural rebalancing of public revenues in favour of direct taxes bodes well for the long-term stabilization of public finances and makes the state budget slightly less dependent on domestic consumption.

Chart 6. Structure of main fiscal revenues, January – August, 2011



Source: Ministry of Finance and EG calculations;

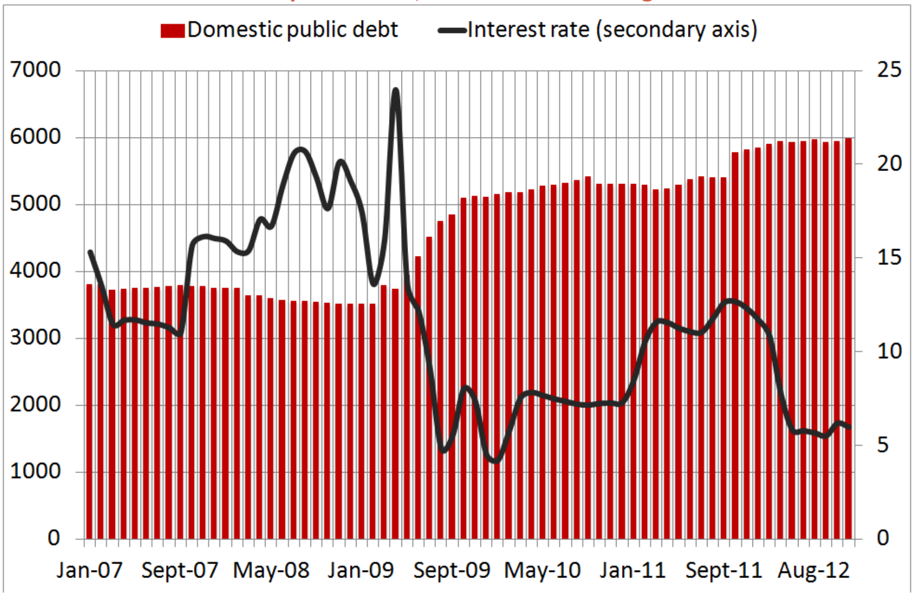
Chart 7. Structure of main fiscal revenues, January – August, 2012



Source: Ministry of Finance and EG calculations;

Loans obtained from international organizations served as the main source financing the state budget deficit by covering about 40% of deficit during the period January - August 2012. Coupled with the massive budget support from foreign grants, this reveals the strong reliance of the Moldovan Government on foreign partners in attaining fiscal consolidation. Another important source of filling the fiscal gap, which has persisted since the economic crisis of 2009, is the domestic borrowing from commercial banks through T-bills. In this way, the Government takes advantage of the abundance of idle resources on the banks' balance sheets and their increased reluctance to lending amid current macroeconomic uncertainty. Additionally, the monetary policy easing and higher demand for T-bills made the borrowing costs to decrease markedly. All in all, it created advantageous conditions to smooth the budgetary expenditures and mitigate the distorting effects of fiscal policy tightening by increasing the domestic public debt. One may notice the jump in the stock of issued T-bills in autumn 2011, when the first signs of economic slowdown appeared and the interest rates on T-bills slumped (Chart 8).

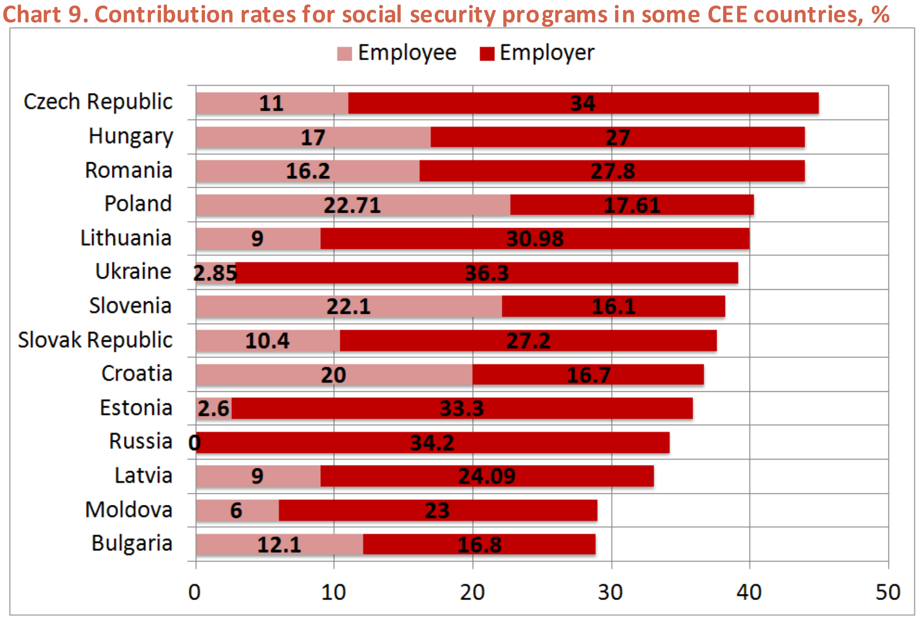
Chart 8. Stock of domestic public debt, mil. MDL and average interest rate on T-bills, %



Source: Ministry of Finance;

The project of the state social insurance budget that recently entered the Parliament proposed the raise of the social insurance contribution rate paid by employees from 6% to 7%, while that of employers to be cut from 23% to 22%. While at least theoretically, the decreasing fiscal burden on employers could diminish their incentives to pay undeclared wages, there are other factors considered by both employer and employee when negotiating the wage (seem Chapter 4). Nevertheless, as Chart 9 reveals, the employees' share in the cumulative rates for social security programs in Moldova is one of the lowest from the region and there is space to increase it. However, no major improvements may be expected until the pension system is radically reformed and the trust in the pension system is rebuilt.

Chart 9. Contribution rates for social security programs in some CEE countries, %

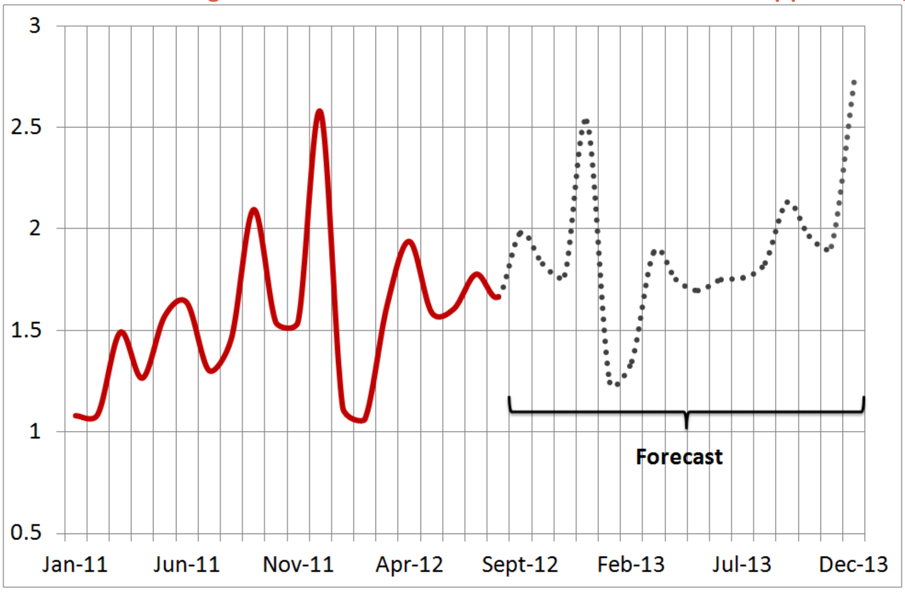


Source: Social Security Programs Throughout the World: Europe 2010;

Short-term challenges and forecasts

- Public finance stability is currently threatened by three important factors: (i) economic deceleration and cooling of domestic demand, which makes the budget revenues to constantly underperform as compared to the planned level; this is mostly related to the VAT and excises collections forming the largest share of total state budget revenues; (ii) the economic fallout from the recent drought will add to this burden, with the strongest impact to be seen starting the fourth quarter 2012; (iii) the fiscal consolidation is also threatened by over-confidence of public officials regarding the macroeconomic prospects.
- The main risk of the Government's over-confidence bias consists in fuelling excessive spending commitments which might not be sufficiently covered by existing revenues and boost the fiscal gap above the planned level. This has been the main reason for the last amendment to the state budget for 2012, when the Government had to adjust its parameters to the economic growth slowdown. Nevertheless, in our view the public estimates remain too optimistic. As a result, public revenues are expected to continue to perform under the planned level in the near future. We expect state budget revenues to increase by 9% in 2012 (compared to Governmental estimates of 13.8%). If our forecast turns true, it is likely to create a liquidity gap of about MDL 800 million which most probably will be financed through increase in domestic and foreign debt.
- The project of the state budget law for 2013 is based, as well, on excessive optimism regarding macroeconomic conditions. The official projected economic growth of 5% is almost twice above our forecast. The total amount of state budget revenues for the end of 2013 is officially estimated to be by 7.6% higher in comparison with the planned level for 2012, more optimistic in comparison with the Expert-Grup forecast (+4.1%) (Chart 10). In case the Government's scenario does not materialize, it will create a discrepancy of about MDL 720 million between the planned and de facto state budget revenues, which could threaten the fiscal stability. Therefore, if the state budget law is finally approved under the current parameters, it is likely to be amended during the next year in order to ensure the sustainability of the spending commitments.

Chart 10. State budget revenues based on two different econometric approaches[7], bil. MDL



Source: EG calculations;

[7] The forecast has been derived from a structural vector autoregressive model (SVAR) with 2 lags, based on monthly frequency, for the period 2004-2012 (august). The model takes into account the amount (expressed in natural logarithms) of imports, exports, money in circulation and state budget revenues, as well as the trends and seasonal dummies for each variable.

Policy recommendations

- Whereas the current circumstances are relatively advantageous for borrowing on the domestic market, which makes the deficit financing easier and less costly, in the medium term a major challenge is related to improving the forecasting capacities of the Government. Excessive optimism related to planned budgetary revenues and expenditures creates the risk of getting higher-than-expected budgetary deficit, while financing it during normal economic conditions creates a significant crowding-out effect of private investments. The Government has to improve its forecasting capacities in order to ensure a higher certainty about the realization of the state budget under the planned parameters without resorting to additional financing sources.
- The current fiscal consolidation is based mainly on: (i) massive foreign assistance, both in terms of foreign grants and loans from international organizations; and (ii) the reintroduction of the corporate income tax and increase in excises for a series of products from the beginning of the current year. Both factors are likely to have only short-term effects, while on a medium and long-term the fiscal stability should be ensured by: (i) a more efficient collection of taxes, especially by the customs authorities; (ii) counter-cyclical fiscal and budgetary policies aimed at accumulating surpluses during times of economic growth which could turn into deficits during economic shocks; and (iii) the Government should significantly increase the transparency of the elaboration process of the state budget, as well as broaden its consultations with the civic society and stakeholders on this matter.
- The Ministry of Finance has recently issued a public policy proposal advocating for the necessity to launch a new type of T-bonds with a maturity of three years and with a fixed interest rate. Obviously, as the majority of T-bills have a maturity of less than 1 year, which creates high uncertainty and exposes the state budget to multiple risks, this sounds like a welcomed initiative. However, this problem should be addressed from a broader perspective. Particularly, the lack of interest for T-bonds with longer maturities is not the cause of short maturity of public domestic debt. It is rather the effect of insufficient "long money" within the Moldovan economy. Therefore, given the fact that the main investors on the T-bills market are commercial banks struggling with the same problem (lack of long-term financing sources, as most of deposits have a maturity lower than 1 year), the introduction of new T-bonds, though with a fixed rate, will not essentially change the situation. Therefore, in addressing this issue the Government has to create all the necessary circumstances for channelling the "long money" into the economy and creating incentives for investors to channel their resources in long-term financing instruments. This can be done mainly by: (i) developing a functional multi-pillar pension system (traditionally, the main source of long-term maturities serves the pension funds which use T-bonds as long term risk-free investments); (ii) extending the access of insurance companies to the T-bonds market; (iii) consolidating the public confidence in the banking system, such that the population would be motivated to set up long-term deposits; (iv) increasing the popularity of T-bonds as an alternative to bank deposits for holding the savings (it is necessary to develop a functional competition between bank deposits and t-bills/T-bonds).
- Due to worsening of demographic situation and low labour productivity, the current pensions system poses significant risks for the long-run budgetary stability[8]. Covering the state social insurance budget deficit directly from the state budget, which for 2013 is planned to be about MDL 856 mil., is an unsustainable mechanism and creates important opportunity costs. Hence, in order to ensure the inter-temporal fiscal equilibrium, the Moldovan pension system has to be subject to a series of parametric adjustments (e.g. gradual equilibration of the pension wage between men and women) and a comprehensive systemic reform. It is

[8] Lupusor A. (2012): "The Costs of Solidarity among Generations and the Optimal Model of Reform for the Pension System in Moldova", Expert-Grup, http://www.expert-grup.org/old/index.php?go=biblioteca&n=294

necessary to develop a multi-pillar pension system, following the experience of most of the Eastern and Central European countries. Coupled with improvement of investment climate and increasing labour productivity, it could consolidate the long-run sustainability of the pension system and, in this way, restore its credibility.

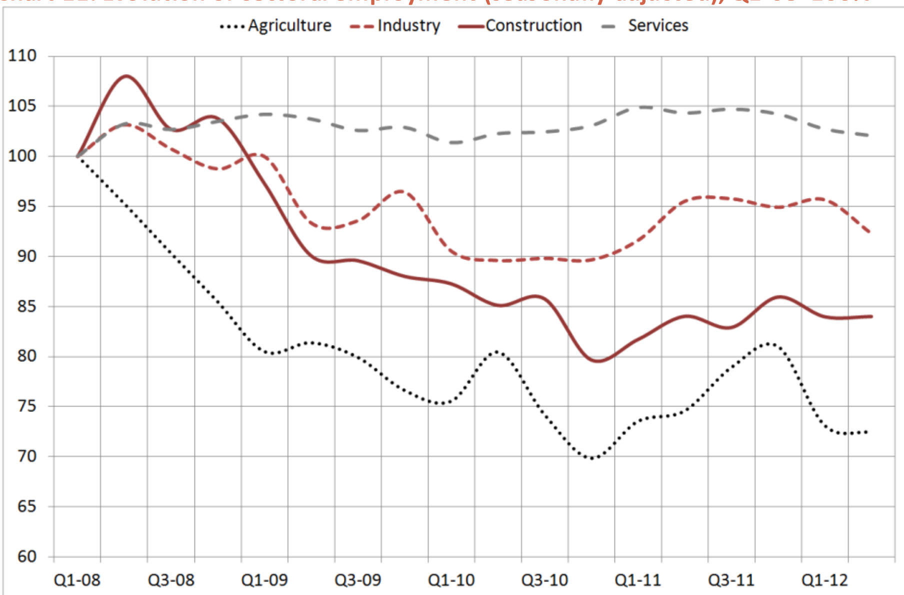
4. Labour Market

The continuous crisis on the labour market

Current economic repercussions from the sovereign crisis seem to have higher impact on the European labour market than during the global financial crisis of 2008-2009. While the employment rate has not improved in EU and Euro area since the first wave of crisis and small variation occurred mainly in negative direction, the unemployment rate increased significantly since then, rising the most during the last year. In the second quarter of 2012 unemployment rate in EU 27 was 0.9 p.p. higher and in Euro area - 1.4 p.p. above the level of second quarter of 2011.

Moldovan labour market reflects the external trends that superpose on the 'natural' declining trends of employment in some sectors. The decrease in employed population was quite significant in the second quarter - 3% y-o-y - and it took place in all major economic sectors (Chart 11). This way, Moldova reached a new season-specific low of 40.5% for employment rate. While in agricultural sector the decline in employment was expected due to unfavourable weather conditions, the decrease in agricultural employment was weaker than in other sectors so far (2.4%). We expect the most significant negative impact to occur in the third quarter, in result of cumulate effects of the drought in spring and summer 2012.

Chart 11. Evolution of sectoral employment (seasonally adjusted), Q1-08=100%

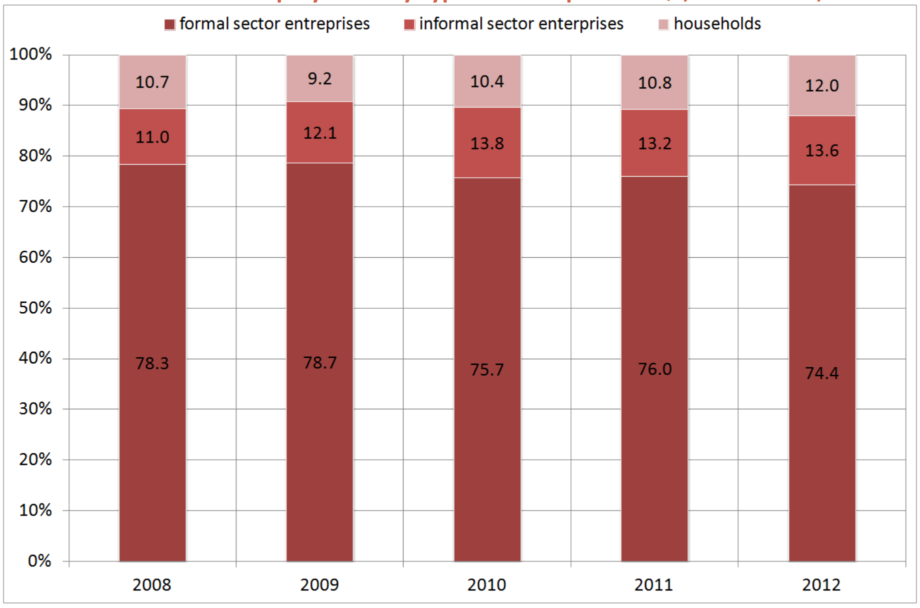


Source: Expert-Grup calculations based on NBS data;

The decline in employment in industrial sector was 3.4% y-o-y in the second quarter. A further decline in industrial employment might be expected due to the impact of low agricultural production on the food-processing industry. Given the high share of food processing industry in the total industrial employment and the lags with which the sub-sector reacts to the evolutions in the agricultural sector, we expect negative impact on employment in the food sector to be visible up to the second quarter of 2013. Meanwhile the employment in construction sector decreased the most – by 5.2%, corresponding to the decrease in the construction works in the second quarter of the year. In services sector employment also went down by 2.9%, the decline being generated mainly in market services sector: trade, hotels and restaurants.

The decline in total employment was accompanied by the reduction in employment in formal sector enterprises taking place for two quarters in a row. In Q2-12 it went down by 5% compared to the previous year. At the same time employment in informal sector enterprises was more or less stable, while employment in the households rose by 8.4% in the second quarter and by 9.8% in the first quarter, this being the only opportunity for those who lost their formal jobs, but unable to cover all individuals who lost their jobs (Chart 12). Thus, the social impact of the labour market instability is disproportionally higher compared to the loss of jobs and it is amplified by the loss in social protection mechanism by many individuals staying on the labour market, but transiting to informal sector enterprises. Meanwhile informal employment, including undeclared salaried-workers, also declined that should content the authorities given the high concern for the reduction of undeclared work. However, this does not solve the problem itself, as most of the individuals who lost their jobs are in higher need for social protection mechanisms.

Chart 12. Structure of employment by type of enterprise in Q2, 2008-2012, %



Source: Expert-Grup calculations based on NBS data;

Not a paradox anymore for Moldova, unemployment rate fell to a new historical minimum after the crisis. The unemployment rate reached 4.5% in the second quarter of 2012 with the number of registered unemployed also shrinking during the second and third quarter. The unemployment fell mostly in rural areas – by 48% - and for women - by 34%. The reasons for this low unemployment were mentioned in the previous editions of MEGA and it is already clear that unemployment rate cannot be properly used to characterize the state of Moldova economy. According to ILO standards for a person to be considered unemployed, the person must be "undertaking active measures for seeking a job" and given the few opportunities available on Moldovan labour market to find a well-paid job, many Moldovan citizens do not look actively for a job, remaining inactive in the country or leaving for a job abroad. Moreover, the agricultural plots owned by most rural inhabitants offer alternatives to formal work and help people survive. Thus, while persons exclusively engaged in the production of agricultural goods for own consumption of households, with a working week of 20 hours or more are considered employed, many of them would like another paid job and consider themselves as unemployed.

Other labour market indicators have remained quite positive given the evolution of employment and unemployment rates: the share of discouraged persons in the inactive population and the number of underemployed decreased. At the same time, despite the tougher situation on the external labour markets, migration seems to be the main option for many individuals inactive on Moldovan labour market. The number of emigrants increased by 11% in the second quarter compared to previous year. However, the gender structure of the new emigrants (an increase of 17.4% in male migrants and only 0.5% in female migrants) indicates the CIS countries as main destinations, while EU labour markets face serious difficulties and are unable to provide new jobs.

Additionally, the evolution of wages points out to the negative perspectives in some specific sectors that might eventually result in jobs closures if the situation on the external markets does not improve. While the real wages increased overall in the economy during the whole summer, there are few sectors showing a negative evolution of real wages for 3-4 months in row, especially in industrial sector: tobacco production, production of leather articles and shoes, production of paper and paperboard, printing industry, chemical industry, metal industry, production of non-metal minerals, machinery and equipment, radio, TV and communication equipment. These are mainly export-oriented industries and wage reduction is explained by the difficulties within the companies that face declining demand for their goods. However, some of the companies (i.e. tobacco industry) also suffer of deep-rooted inefficiency problems that result in worsening of indicators across the board.

Meanwhile, the trade unions in Moldova are worried about the potential decrease in net wage incomes of the employees since a rise in the social contribution for the employees by 1 p.p. is planned starting from 2013. The high and growing deficit of the State Social Insurance Budget calls for radical changes in the financing of the system. While, the share of contribution paid by the employee is lower than in many other CEE countries, we believe that the Governmental argument that by transferring part of the employers' contribution to the employee the incentives for formal work and declaration of wages will increase is not fully valid as most of the employees negotiate their net revenue with the employer and the decision/agreement on the taxes to be paid is made afterwards. In the current context, this measure may actually decrease the net wages if no rise in salaries is performed, or keep them stable if the increase is marginal. Nevertheless, certainly there are issues to be solved in this context. Firstly, the deficit in the State Social Insurance Budget makes its financing unsustainable and this will not change until a totally new approach is implemented - the introduction of multi-pillar pension system. This measure is also able to motivate employees to contribute to the pension system, as the future pension is usually seen by the natural persons as the main reason in favour of paying taxes. Thus, the incentives to work in formal sector will not appear by only a change in the contribution, but through a significant increase in quality and access to services and goods intended to be delivered in exchange of taxes paid.

Short-term forecast and challenges

- The persistence of unfavourable weather conditions during the third quarter of 2012 made us revise downwards the forecast for agricultural employment to a decline of 8 to 11% by the end of the year. For 2013 we expect the employment in agricultural sector to be stable, but very much dependent on the final outcomes in the agricultural sector this year. Taking into account the impact the agricultural production has on the food-processing industry and the negative evolutions in some export-oriented industries, we expect a decline in employment in industrial sector of 1.5% in 2012 with no major changes in 2013. As the situation in the construction sector worsened significantly in the second quarter, we revised the forecast for employment based on GVA evolution and consider 1% increase in possible for 2012. However, both for 2012 and 2013 the evolution of the sector depends very much on the public investments. According to our estimates employment in service sector will slightly fall by up to 2%.
- Given the above sectoral forecasts and the hypothesis that employment in public sector will remain stable, the employment rate may drop to 38-39% in 2012. As for the unemployment rate, it is difficult to be predicted due to lack of correlation between the employment and unemployment rate registered by now and, as it was mentioned above, it lost from its descriptive power for Moldova.

Policy recommendations

- All policy recommendation addressed to create a healthy labour market are mostly long-term actions with no immediate impact. Therefore, all recommendations from previous editions of MEGA are still valid and the most important one is that higher employment is the result of a more intense business activity which may increase only when the business climate is appropriate. Most of the policy recommendations mentioned in this publication are intended for a better business climate and consequently, for job creation.

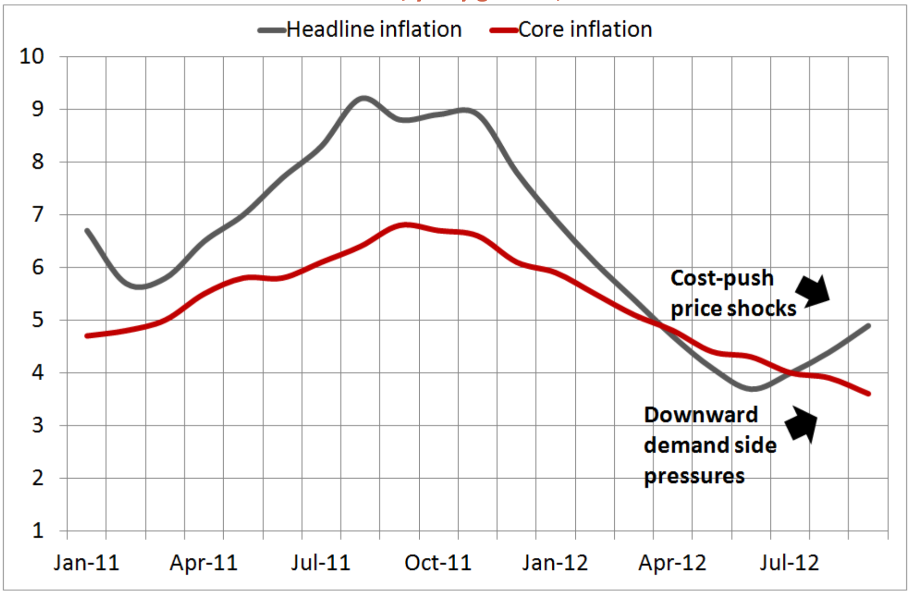
- At the same time, a new approach to human capital creation should be implemented. A comprehensive reform is needed at all levels of education in order to eliminate human capital deficit and mismatch in the labour market. From the perspective of labour market, secondary vocational and higher education need the most significant interventions. For the increase in the quality of education a set of measures are necessary: creation of an independent agency for accreditation of educational institutions, change in the curricula, more active implication of the business sector in the formal education reforms, international cooperation in the educational system, etc. The deficit of qualified labour force is already a problem for Moldova and it might intensify in the context of European integration aspirations of our country.
- The level of taxes should not be used as a sole tool to increase the budgetary revenues and change the incentives to pay taxes. Some concessions from the part of the state are also necessary to motivate taxpayers to perform a formal job. Only when the effects are visible to the population they might think conscious to change their attitude towards tax deductions.

5. Prices and Monetary Policy

Disinflationary process counterbalanced by the drought

After a continuous deceleration of annual inflation during the first half of the current year, the headline CPI reversed its trend, increasing from June's low of 3.7% to 4.9% in September. Thus, the disinflationary pressures caused by the slowdown in economic activity has been counterbalanced by the cost-push price shocks associated with the regional drought and tensions in the Middle East, pushing the food and fuel prices up. At the same time, the demand-side inflationary pressures are insignificant, given the weak economic conditions and dwindling domestic demand. As a result, the trend reversion of headline CPI was not paralleled by similar evolution of the core inflation, owing to the dominance of cost-push price shocks triggering the inflationary environment (Chart 13).

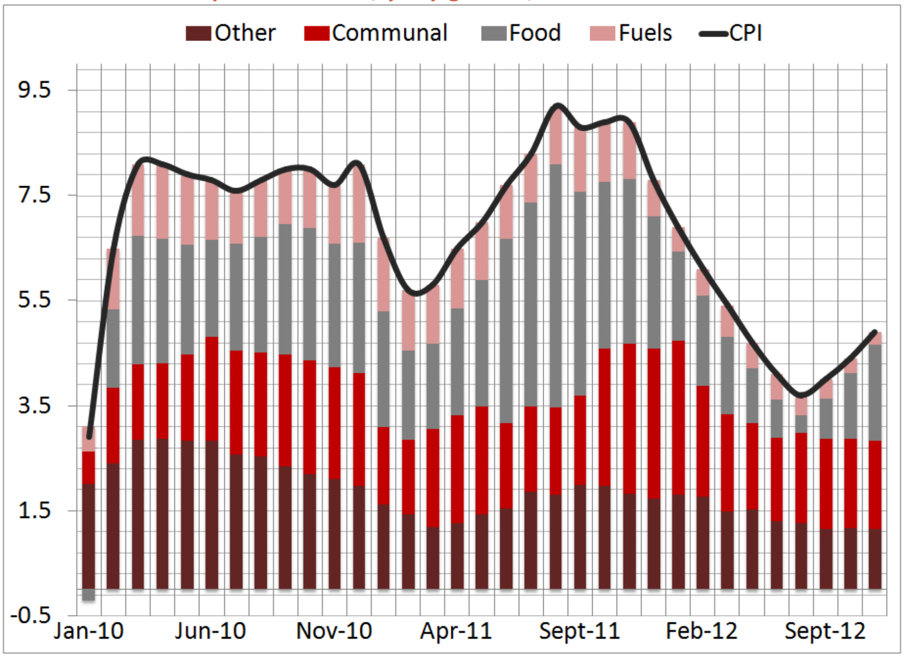
Chart 13. Headline and core inflation, y-o-y growth, %



Source: NBS;

The upward trend reversion in CPI was primarily driven by the increase in prices for vegetables, fruits, meat and dairy products, which at the end of September were more expensive by 28.4%, 7.2%, 8.7% and 6.6% accordingly as compared to the previous year. Chart 14 confirms the strong contribution of the food price components of the CPI to the recent hike in annual inflation. This is explained by the regional drought repercussions, which became visible earlier than officially expected, as well as by the import interdictions of meat from Ukraine. Hence, at the end of the third quarter of 2012, about one third of the 12-months inflation owed to foodstuffs. The direct impact of fuel price on the headline inflation is not clearly visible in Chart 14 due to its low share in the CPI basket, as well as to the fact that it started to increase a bit latter than the food prices. Thus, in August the fuel prices grew by 0.9% and in September – by 1.7% as compared to the previous month. Moreover, its indirect impact on the headline inflation is stronger since it affects the production costs and, therefore, it is spread across the entire economy.

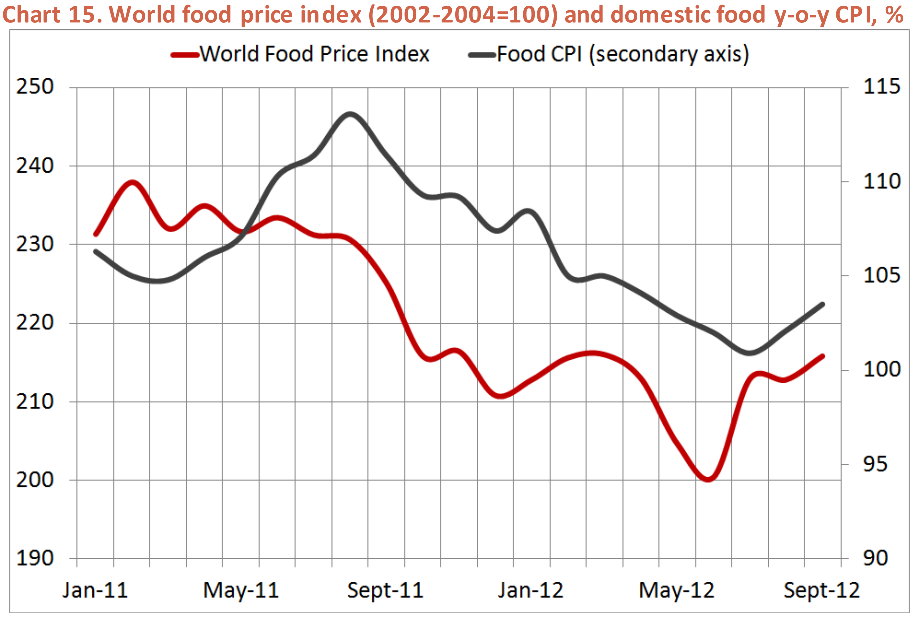
Chart 14. Main components of CPI, y-o-y growth, %



Source: NBS and author calculations;

In addition to the drought repercussions on the domestic supply of foodstuff products, another major culprit for the unexpected increase in annual CPI belongs to the price fluctuations on the regional outlets. Thus, the world food price index followed a similar pattern to the domestic one: it switched from a downward trend registered during the first half of 2012 to an upward one (Chart 15). Given the importance of foodstuffs for the Moldovan foreign trade, the domestic prices are traditionally highly sensitive to the external price shocks. The empirical estimates reveal that, on average, a sudden hike in the world food price index causes a strong rise in domestic prices for foodstuffs which reaches its maximum effect in about six months. Hence, the continuation of this trend in September signals about the persistence for the next months of domestic inflationary pressures triggered by food prices.

Chart 15. World food price index (2002-2004=100) and domestic food y-o-y CPI, %

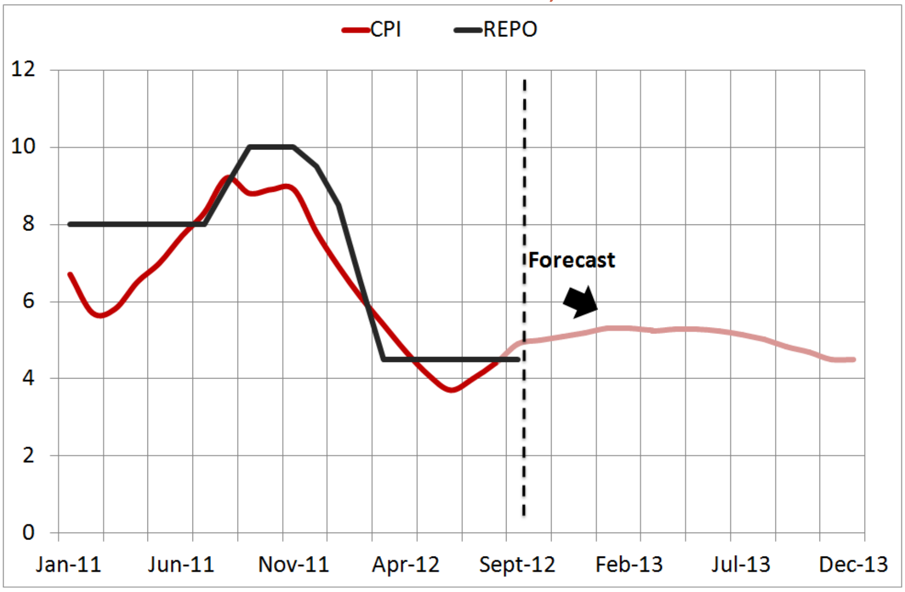


Source: FAO and NBS

Since the recent increase in annual inflation owed exclusively to cost-push price shocks, it did not motivate the central bank to adjust its policy rate, which remained at its historical low of 4.5% (Chart 16). There are three main reasons explaining the NBM's neutral position:

- Firstly, the current inflationary pressures, unlike the demand-driven ones, are out of monetary policy control. It means that if the central bank would try to raise the policy rate under current circumstances, it could depress further the economic activity without major effects on the inflation rate. These risks are fuelled by the downward trend of core inflation which reflects the disinflationary process caused by the slowdown in economic activity.
- Secondly, the cost-push price shocks are, usually, not persistent in the long run which implies an expected trend correction in the near future. This is denoted by the annual CPI outlook for 2012 and 2013. Hence, given the slow speed of monetary policy transmission and since on a medium term the headline inflation is expected to hover around the central bank's target of 5% (± 1.5 p.p.), any policy changes would be unnecessary.
- Thirdly, the central bank should avoid policy induced volatility and keep its accommodative stance of monetary policy as a means to tackle the current credit squeeze and tempering of economic activity. Thus, the policy rate is likely to be kept at the current levels for the next months.

Chart 16. Annual CPI and central bank's REPO rate, %

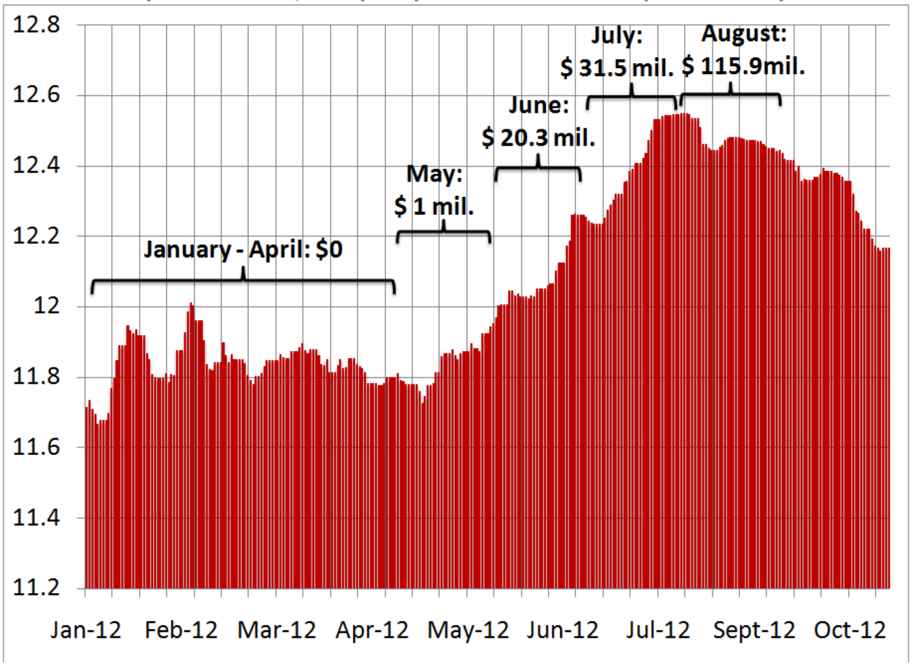


Source: NBM, NBS and author calculations

All in all, the current monetary policy stance can be considered appropriate, as the policy rate is slightly below the projected CPI for the next 10-12 months and almost at the level of the medium term inflation outlook. In this way the policy stance remains accommodative since the real policy rate is near zero bound, which is consistent with the necessity to stimulate the credit growth and the overall economic activity.

Nevertheless, while NBM remained neutral with respect to its policy rate, apparently, it resorted to an indirect instrument of inflation stabilization – national currency exchange rate. Thus, during May – August, it purchased USD 168.7 million on the FOREX market causing, in this way, a controlled depreciation of the national currency by about 6% during the same period of time. Hence, the central bank took opportunity of the disinflationary pressures in order to augment the level of international reserves and, at the same time, to spur the price competitiveness of Moldovan exports (Chart 17).

Chart 17. Daily official MDL/USD parity and the amount of purchases by NBM of foreign currency



Source: NBM

Short-term forecast and challenges

- Given the stronger-than-expected price hike associated to rising food prices due to drought effect, we revised upward our baseline forecast for the headline inflation for the end of 2012 from 4.1% to 5.2%, y-o-y. During the first half of 2013 the annual CPI could remain slightly above the level of 5%, after which it should stabilize at 4.5% till the end of the next year.
- Demand side inflationary pressures will remain low amid moderating economy and tepid demand. However, they could rebound in the second half of 2013, when the economic conditions are expected to improve. As for now, the combination of cost-push price shocks and demand-side disinflationary trend poses major challenges for the monetary policy. Unless the current circumstances will change, the central bank might keep its policy rate unchanged till the end of the current year. During the next year some adjustments could be necessary in order to effectively anchor the inflationary expectations at the targeted level.
- Poor foreign demand and low demand-driven inflationary pressures might give the central bank additional incentives to continue its interventions on the domestic FOREX market in order to augment the level of international reserves and support the price competitiveness of Moldovan exports. On its turn, this might cause a gradual and controlled depreciation of the national currency.

Policy recommendations

- Given the weak economic conditions which are likely to persist during the first half of the next year, the central bank should maintain its accommodative policy stance in order to further support the credit growth. It implies keeping its policy rate close to the level of medium-term inflation outlook, which is now about 4.5%. At the same time, NBM should not react to cost-push price hikes given their short-term impact, as well as the proven monetary policy inefficiency in dealing with such shocks. It will prevent unnecessary policy volatility and distortionary effects on the economic activity.
- Despite the fact that the central bank could be tempted to use exchange rate as a monetary policy tool, relying actively on it poses significant risks. Besides the fact that massive interventions on the domestic FOREX market impedes the currency exchange rate to adjust

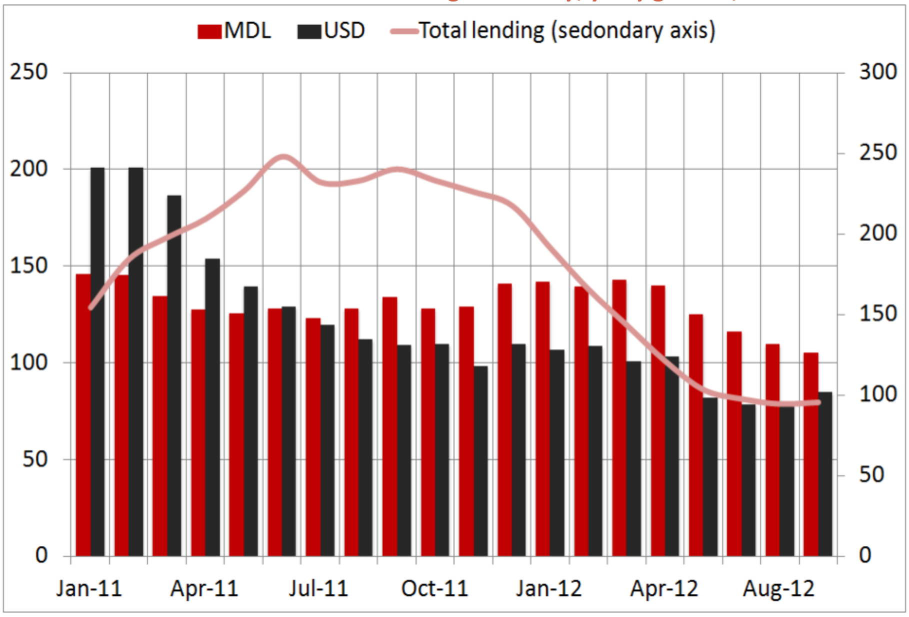
based on market forces, it could cause unnecessary over-depreciation of the Moldovan leu. The reason is that such interference on the market amplifies the existing depreciation pressures determined by weaker demand for national currency given fewer exports, remittances and FDI. Hence, the NBM's interventions on the domestic FOREX market should be aimed exclusively at mitigating the excessive exchange rate fluctuations instead of amplifying them, while its main policy instruments should remain the refinancing rate and open market operations.

6. Banking Sector

Building liquidity walls to survive the potential crisis

The weak economic conditions and high uncertainty has taken a heavy toll on the lending activity of Moldovan commercial banks. Thus, the slowdown in the year-on-year growth rates of the new loans, which has started in the second half of the previous year, turned into a moderate credit squeeze in 2012. In August the total amount of new loans has been 5.7% lower compared to the same month of the previous year. This negative trend was primarily triggered by foreign currency credits which, during eight months of 2012, decreased at an average rate of 15.5% in y-o-y terms (Chart 18). This credit contraction has at least two explanations. On the supply side, the banks attempt to immunise their portfolios against the risks associated with exchange rate volatility amid harsher economic conditions in the European Union. On the demand side, companies postponed their investment plans for better times, which translated into a lower demand for foreign currency bank loans. However, another major concern is related to the downward trend in year-on-year growth of lending in national currency, which has started at the beginning of the current year and turned already into a negative growth in august (-2%) – the first decrease since the end of the economic crisis of 2009. Thus, besides the exchange rate risks, the banks are also dealing with credit and market risks, fuelled by the slowdown in economic activity and high uncertainty.

Chart 18. New loans in national and foreign currency, y-o-y growth, smoothed series with MA(5)[9]

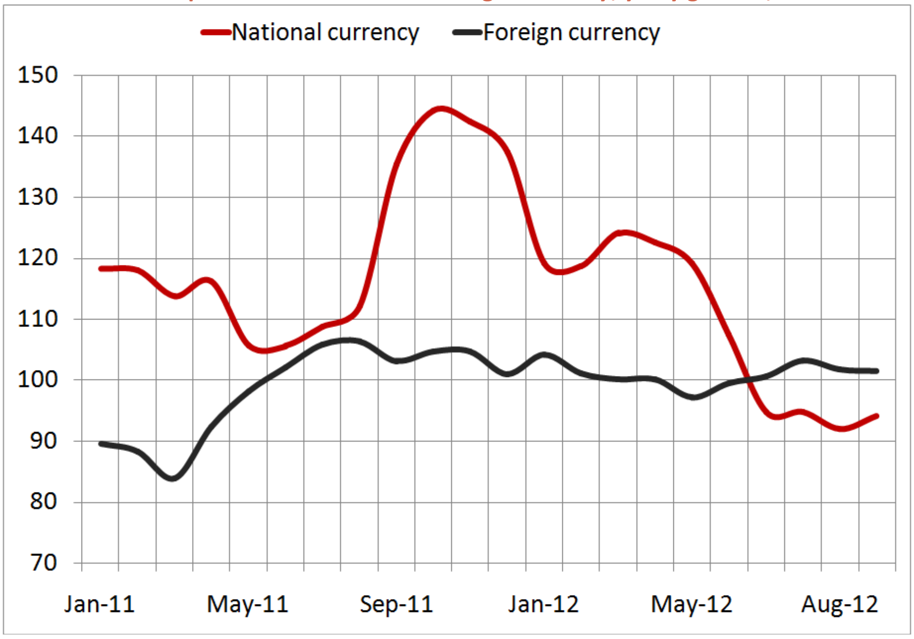


Source: NBM and EG calculations;

The highly volatile deposits served as an additional factor explaining the banks' reluctance towards lending. This is mostly related to the downward trend in national currency deposits which has started at the end of the previous year (Chart 19). The main contribution belongs to the deposits opened by households who are trying to smooth their consumption given the slowdown in remittances and overall disposable incomes. As of end of August the new deposits opened by physical persons decreased by 19.1% in national currency and 31.7% in foreign currency, y-o-y terms. At the same time, such a strong contraction is counterbalanced by the increasing deposits set up by companies. In this way, firms use bank deposits to store their idle cash resulted from postponing certain investment projects until the economic conditions improve. During the same period, the companies opened up by 55.4% more deposits in national currency and over 6.5 time more deposits in foreign currency as compared to the same month of the previous year.

[9] Moving average filter was used in order eliminate the excessive volatility in the y-o-y growth of new loans;

Chart 19. New deposits in national and foreign currency, y-o-y growth, smoothed series with MA(5)[10]



Source: NBM and EG calculations;

Such a strong reluctance against lending helped banks to keep their liquidity indicators constant at safe levels. Obviously, this conservative approach has certain opportunity costs which translated into decreasing profitability levels, fuelled additionally by the worsening banks' portfolios: the share of non-performing loans increased in the first eight months of 2012 from 13.5% to 15.3%. This deterioration of the quality of banks' balance sheets is explained by the financial difficulties faced by many debtors under the pressures of weak domestic and regional economic situation.

Although the increase in the share of non-performing loans was experienced by most of commercial banks, a significant contribution had the worsening of the situation at two most problematic banks. The most important one, with a share of about 12.3% in the banking industry, is the state-owned "Banca de Economii", which at the end of the second quarter struggled with a share of 41.9% of bad loans out of total credit portfolio. Additionally, as a result of previous risky lending practices, it does not have enough capital to comply with the minimum required level to cover the risk-weighted assets: at the end of the second quarter the capital adequacy ratio was only 7.98%, which is twice lower the minimum threshold of 16%. Fortunately, the bank has an adequate liquidity position with 41.3% of total assets being liquid which helps it to remain solvent. The second bank has a lower, but still important systemic role – "Eximbank – Gruppo Veneto Banca" - with a share of 7.7% of the banking industry and 42.8% of credits categorized as non-performing. Still, such a high share of toxic assets are counterbalanced by adequate liquidity level (28.4% while the minimum required level is 20%) and, especially, the sufficient amount of capital which well covers the risk weighted assets (capital adequacy ratio is 38.5% which is over twice higher the minimum required level).

The overall worsening of the risk profile in the entire banking sector was also denoted by the increasing gap between the short-term liquidity and capital adequacy ratio noticed since the beginning of the current year (Chart 20).

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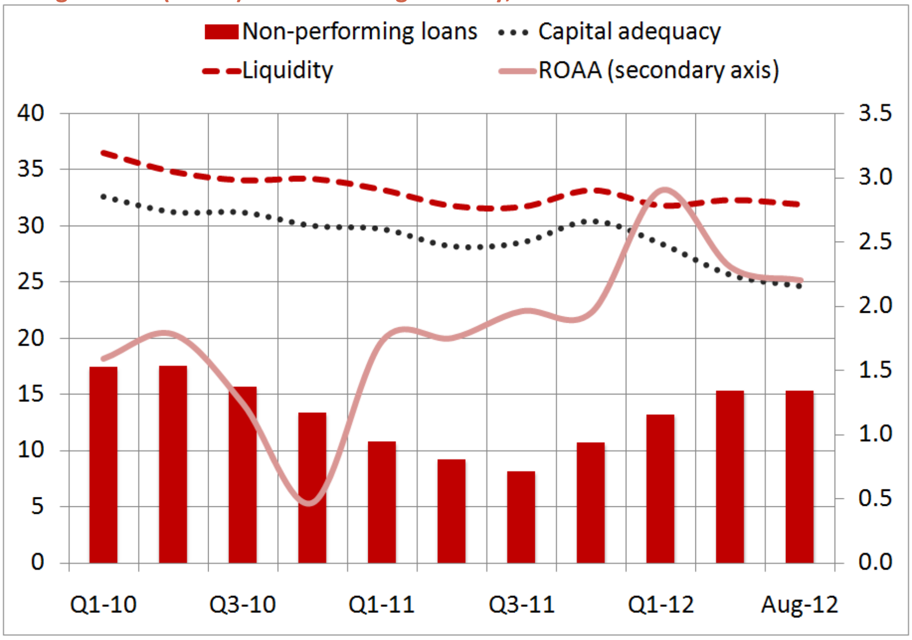
[10] Moving average filter was used in order eliminate the excessive volatility in the y-o-y growth of new loans;

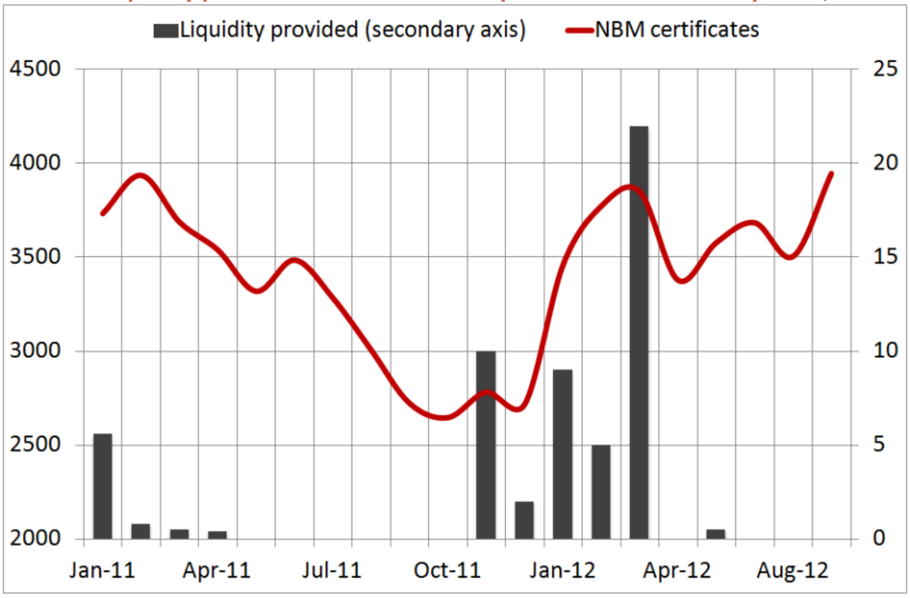
Chart 20. Non-performing loans as a share in total loans, short-term liquidity, capital adequacy and return on average assets (ROAA) in the banking industry, %



Source: NBM;

Despite the slight decrease in the capital adequacy ratio, most of commercial banks remained liquid and sufficiently capitalized, which is confirmed by their net crediting position in relation to the central bank. Thus, the available facilities for liquidity provision opened at NBM either as a direct credit line to any commercial bank or temporary repurchase of T-bills were almost intact since 2011. The most active period when the Moldovan banks resorted to the lender of last resort has been November 2011 – March 2012, during which NBM debited an amount of MDL 48 million loans to banks. On the contrary, the commercial banks became quite eager to store their idle resources in safe NBM certificates. As a result, the liquidity sterilization operations markedly increased after the overall macroeconomic situation began to deteriorate – a process which can fairly be considered a flight to safety by the Moldovan banks (Chart 21).

Chart 21. Liquidity providedand sterilization operations conducted by NBM, mil. MDL



Source: NBM;

Short-term forecast and challenges

- Given the abundant liquidities and net crediting position in relation to NBM, the commercial banks do not face any major liquidity constraints and have all the necessary fuel to accelerate the engine of the Moldovan economy. The main problem remains the uncertain economic prospects, both at domestic and regional levels, which keep the risks up and explain the banks' reluctance towards their lending activity.
- The share of non-performing loans should stabilize at the current level unless the economic conditions will continue to deteriorate. Most banks undertook all the necessary actions in order to keep their balance sheets liquid and, in this way, remain solvent and ensure a smooth operational activity. The main challenge is faced by two banks which amount for about 20% of the total banking system and where the share of non-performing loans is over 40% of total credits. Although these banks remained stable, the process of cleaning the books of these toxic assets is likely to be slow due to the legislative loopholes related to debt restructuring and high amount of accumulated bad loans.
- Lending is likely to remain tepid given the weak domestic and regional economic conditions and high uncertainty regarding the macroeconomic prospects. Hence, the banks' preference for risk free investments such as T-bills and NBM certificates will remain high which creates favourable circumstances for financing the fiscal gap at lower costs (see chapter "Public Finance").

Policy recommendations

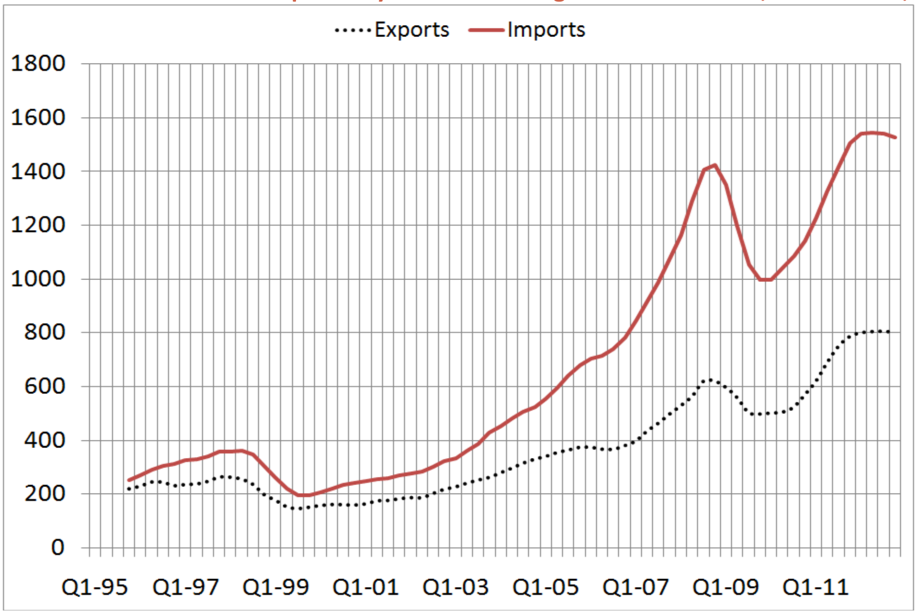
- The central bank should undertake urgent actions for restructuring the high amount of bad loans accumulated at the mentioned two most problematic banks and induce them to stop eventual risky lending projects. The situation at the state-owned bank is of particular importance given its important systemic role. Thus, despite the fact that it accounts for about 12% of total banking assets, it has the highest density of branches all over the country. Therefore, any distress in the activity of this bank can strongly harm the population's credibility in the entire banking system – the most important risk to be avoided amid the current difficult economic situation.
- The monetary policy should remain accommodative in order to ensure the liquidity abundance from the banking sector to solve, at least partly, the liquidity constraints from the real sector. Thus, keeping the policy rate low (approximately at the level of mid-term inflationary expectations) will increase the opportunity costs of holding cash and motivate banks to expand their lending portfolios and, in this way, to decrease the share of bad loans. Nevertheless, we have to expect that, due to high risks and uncertainty, this process is likely to be slow and the effects of monetary policy decisions – moderate.
- A major culprit for slow restructuring of bad loans and which, also, explains banks' restrictive conditions at granting credits is related to poor lenders' rights in Moldova. Hence, the Government has to improve the insolvency legislation in order to remove the redundant bureaucratic barriers for collateral execution. The disputes between creditors and debtors should not be so time-consuming and the impediments for resolution of problem loans have to be removed. It would allow banks to easier clean their balance sheets from toxic assets and be less reluctant in their lending activity, which is especially important given the current macroeconomic constraints.

7. Foreign Sector

More fallout from the EU sovereign crisis and drought

As we expected in the previous issue of the MEGA, after a relatively good start of the year, the evolution of the Moldovan foreign trade worsened during the second half of 2012. Our estimates suggest that in Q3-12 the Moldovan exports of goods posted a 14% y-o-y decline, while imports declined 3.0% y-o-y, with the general trade conditions expected to worsen further till the end of the year (Chart 22). However, we expect imports to decline more visibly in the fourth quarter. The speed of trade's deterioration has been particularly fast, as shown by the fact that in the first half of the year both exports and imports were on the positive growth path (4.6% and 3.9% growth, accordingly).

Chart 22. Evolution of the quarterly trade flows of goods and services, million USD, Q1-95 – Q3-13



Source: NBM, forecast for Q3-Q4-12 by EG;

The deterioration of exports was caused mainly by the weaker demand on the European markets and by the economic impact of the severe drought. The former factor is responsible particularly for the fall in exports of leather products (-7%), clothes and related accessories (-6%), metal products (-50%, with the brunt of the decline falling on the Transnistrian companies). The unusually severe drought has reduced the output and exports of important food products, including fruits, cereals, various food preparations, oleaginous seeds and others. As we predicted in the MEGA no.6, the exports to CIS and to other destinations (including Turkey, China, US) have shown more strength, reflecting the efforts of some Moldovan producers to diversify their market outlets away from the large markets.

The decline in imports is mainly due to the reduction in volume of imports from the CIS countries (particularly from Ukraine) and also from some EU countries (including as big as UK and Germany). A great part of the reduction in imports is actually directly related to the falling exports, as a significant part of Moldova exports result from the outward processing agreements with European companies.

Trade in services has displayed similar trends to trade in goods. However, the exports of services plummeted even faster than those of goods: the rate of growth went from 13% in Q1-12 down to nil in Q2-12, with an estimated reduction of 4% in Q3-12. The imports of services have been more resilient, with an average rate of growth of 12% quarterly in 2012, but with clear signs of deceleration in Q4-12.

The economic fallout from the sovereign crisis in the EU has also tempered the growth of income and unilateral transfers from abroad. To compare only the most important figure, the transfers from migrants in Q1-Q3-11 have boasted a 21% growth, whereas in 2012 the corresponding figure was only 2%. However, as the volume of income and remittances from abroad did not shrink in absolute terms, while the imports have declined faster than exports, the combined effect of these evolutions on the current account has been positive.

The global economic recovery, while continuing, has suffered new setbacks in mid and late 2012. The main cause of the worsening situation is that fiscal and monetary policies in the developed economies have not yet rebuilt the confidence in medium-term consumption and output prospects. Viability of the euro area, major mistakes in the US fiscal policies, new tensions in the Middle East, less optimistic prospects of economic rebound in China, all these scarred investors. In short term the evolution of the Moldovan exports will also depend on the economic growth registered by the Moldova's main trading partners. Economic developments in the third and fourth quarter of the year worsened in most of the countries which are major destinations for Moldovan exports, including EU, Russia and Ukraine. Conditions for Moldova migrants working in EU and CIS have also worsened, as reflected by the growing unemployment rates. The labour market setbacks reflected onto the level of remittances sent by Moldovan migrants back home.

The worsening economic prospects globally reflected on the prices for key commodities. While the oil has seen some more upbeat trend in September - October, the general trend remains that of declining prices. As we forecasted previously (MEGA 6), because of the adverse weather conditions in many parts of the world, there is currently a reverse in the global trend of cheapening of the basic food staples: prices for corn, soybeans and wheat were in early September 4%, 22% and 3%, accordingly, above the levels registered in September 2011. While defining even a short-term forecast is problematic, it is clear that increased volatility is likely to remain the dominant characteristic of the global markets in the months to follow.

Short-term forecast and challenges

- IMF has revised again downwards its global forecast for 2012-2013, down to 3.3% growth for the global economy in 2012 and a sluggish 3.6% for 2013. Even the countries which were expected to see a high pace (including the BRICs) are now set to see slower growth in 2012-2013. For instance, Russia is expected to grow only 3.7% in 2012 and 3.8% next year. The Romanian economy suffered because of the political crisis, with the economy expected to grow only 0.9% in 2012 and by 2.5% in 2013.
- Worsening of the global economic outlook will have a negative impact on the Moldovan exports of goods. We expect that in 2012 the growth of Moldovan goods' exports will be marginally positive (+0.6%)[11], down from +1% that we expected 3 months ago. Exports of goods will resume their growth in 2013, and under best case scenario, the exports will put a 4% growth rate.
- As domestic demand is much weaker than we expected previously, this has also reflected in our forecast for imports of goods for this year: we expect that total figure will be 0.4% below the 2011 level. At the same time, for the next year we believe in a 5% growth rate in total volume of imports. A significant upward risk to this forecast is the unsettled contract problem with the Russia's Gazprom for the delivery of the natural gas (with price likely to go up), and the yet unclear impact of the drought on the mid-term food security situation.
- While we previously expected a worsening of the current account in 2012, it is currently clear that the disparate evolution of the exports and imports and the positive inflows of income and transfers will actually result in a reduction of the pressures on the current account (from

[11] Forecast of Moldova's imports and exports has been done using a SARIMA model;

11.5% of GDP in 2011 down to 7.6% in 2012). However, the pressures will start building again in 2013: as we expect the imports to resume their growth, the projected current account deficit for the next year is about 8.2%.

Policy recommendations

- The policy recommendations for the foreign trade are basically the same as in previous editions of the MEGA. The general trade policy seems to be in line with Moldova's international commitments, however, important barriers to trade stem from the behind-the-border. In previous editions of the MEGA we advocated for a swift and comprehensive revision of the Customs Service regulations which do not correspond to minimal standards of decision transparency and impose new rules on ad-hoc basis. So far, we did not see any important progress in this regard.
- A new policy issue which has been forcefully brought forward by some political forces in Moldova is the proposal of Moldova's accession to the Russia-Belarus-Kazakhstan Customs Union. The adepts of this vector invoke the worsening trade conditions with the European Union and pledge that Moldova's joining the Customs Union will bring more economic and trade opportunities for Moldova. Our economic simulations show that in fact the opposite is more possible: joining the Customs Union and adhering to the customs policy in place will significantly worsen Moldova's general trade opportunities, will result in trade diversion from EU and other destinations and will erode Moldova's competitiveness basis. At the same time, this option is completely against Moldova's commitments of WTO member.
- Moldova currently does not have a contract with Gazprom for the delivery of the natural gas, which brings significant risks for the trade account in 2013. The conflicting points are not the contract itself but the general commitments Moldova adopted when joining the Energy Community Treaty. The key commitment is unbundling of the gas sector, but separating transportation and supply activities. As Gazprom sees these commitments as going against its economic interest in Moldova, the issue went from economic into political sphere. Moldova has very limited options, in fact only two: either denouncing its participation in the Energy Community Treaty or to face higher prices for gas next year. Both options are equally difficult to accept politically, but the former has completely detrimental impact in longer term.

About the Expert-Grup

Who we are

EXPERT-GRUP is a leading economic think-tank in Republic of Moldova. It is member of the PASOS (Policy Association for an Open Society) network comprising 50 policy think-tanks in 27 countries from Central and Eastern Europe and Central Asia.

Our mission

As independent think-tank the Expert-Grup creates the working environment in which the free and non-trivial thinking thrives in order for the institution to be a leading source of unbiased economic analysis and to effectively advocate for innovative ideas and solutions to the economic problems that Moldova encounters along its path of economic transformation, societal development and European integration.

Main activities

- Provide the public with relevant and most up-to-date analysis and forecast of economic trends;
- Offer assistance and consultancy in the decision-making and policy-making processes;
- Promote innovative development solutions and policy models.

Areas of expertise

- Development strategies;
- Macroeconomics and economic systems;
- Global economy and international economic relations;
- Economy of the European integration;
- Monetary and fiscal policies;
- Labour economy, management and business culture;
- Consumer behaviour;
- Industrial and agricultural economics;
- Economy of health and education.

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